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No. 80-1700

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1980

AUDREY M. THOMPSON,
FLORENCE AIN and GREGORY AIN,
DOROTHY E. KAHAN and ROBERT KAHAN,
NANA BERMAN and WILLIAM BERMAN,
Petitioners,

VS.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

PETITION FOR WRIT OF CERTIORARI

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Date: March 13, 1981

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QUESTIONS PRESENTED

Must auditors for the Internal Revenue Service dispose of all issues raised by adjustments made in the course of audit so as to conclude the tax consequences thereof?

Must the United States Tax Court dispose of all of the issues raised by its determinations made in a Decision so as to conclude the tax consequences following thereon?

Must the Circuit Court of Appeals, in the course of deciding an appeal, dispose of all issues raised by the Decision of the United States Tax Court so as to conclude all tax consequences following on its decision?

PARTIES

The parties to the proceedings in the Ninth Circuit and the trial court appear wholly in the caption.

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Appendix A—Decision of the United States Tax Court, Thompson, et al. v. C.I.R., 66 T.C. No. 91, 1024 (1976).

Appendix B—Opinion of the United States Court of Appeals for the Ninth Circuit, filed November 3, 1980, in Thompson, et al. v. C.I.R., 631 F.2d 642.

Appendix C—Petition for Rehearing in the United States Court of Appeals, denied December 15, 1980.

Appendix D—Internal Revenue Code Sections 1311-1314, inclusive: "Part II—Mitigation of Effect of Limitations and Other Provisions."

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PETITION FOR WRIT OF CERTIORARI

Petitioners respectfully request the Supreme Court to review the Decision of the Ninth Circuit Court of Appeals, which affirmed a Decision of the United States Tax Court, which decided certain transactions' tax consequences as they affected petitioners.

OPINION BELOW

The Decision of the United States Tax Court (Appendix A) was filed September 21, 1976, and is cited as *Thompson, et al. v. C.I.R.*, 66 T.C. 1024. On appeal therefrom, the Opinion of the United States Court of Appeals for the Ninth Circuit, (Appendix B) was filed November 3, 1980, and became final after a Petition for Rehearing (Appendix C)

was denied December 15, 1980. The citation is *Thompson v. C.I.R.*, 631 F.2d 642 (1980).

JURISDICTION

The jurisdiction of the United States Supreme Court is invoked under the statutory provisions for petition for certiorari. The judgment and decrees are those of the United States Tax Court in 66 T.C. at page 1024, filed by the Tax Court on September 21, 1976, and the United States Court of Appeals for the Ninth Circuit, *Thompson v. C.I.R.*, 631 F.2d 642 (1980), filed by the Ninth Circuit on November 3, 1980.

The Petition for Rehearing in the Ninth Circuit was denied on December 15, 1980. Time runs for this petition on March 14, 1981.

Jurisdiction is conferred on the Supreme Court by writ of certiorari under 28 U.S.C. 1252.

CONSTITUTIONAL PROVISIONS AND STATUTES

This appeal involves primarily the statutes known as the "Mitigation of Effect of Limitations and Other Provisions," found in the Internal Revenue Code Sections 1311-1314, inclusive. Such sections are set forth in full in Appendix D.

STATEMENT OF THE CASE

There were four cases consolidated for trial before the United States Tax Court. These were *Kahan*, involving Del Cerro I partnership losses arising from interest payments made to Sunset International Petroleum Corporation (hereinafter "Sunset") in 1965; *Ain*, involving an interest

deduction of $5,000, prepaid on a $50,000 note in 1965; *Thompson,* involving a Del Cerro II partnership loss arising primarily from interest payments made by Del Cerro II in 1966 in connection with a joint venture entered into with Sunset; and *Berman,* involving the 1967 losses reported by the Del Cerro II partnership. The United States Tax Court sustained the taxpayers' position in *Kahan,* disallowed the interest deduction in *Ain,* and disallowed the partnership losses in *Thompson* and *Berman.*

Approximately twenty individuals formed Del Cerro I in 1965 to acquire, develop and sell certain unimproved residential property located in San Diego, California. The seller to Del Cerro I was Sunset. Also in 1965, approximately thirty individuals purchased stock of a corporation (hereinafter "McAvoy Corporation") which had obtained rights to acquire, develop and operate certain unimproved commercial real property located at Thousand Oaks, California. The seller of such property to the McAvoy Corporation was Sunset.

Approximately fifty individuals formed Del Cerro II in 1966, combining Del Cerro I and the McAvoy Corporation. In 1967, Del Cerro II settled all contractual relationships with Sunset. Losses to Del Cerro II in 1967 exceeded the basis of the partners in Del Cerro II, determined on a cash basis.

The Internal Revenue Service audited the individuals involved in Del Cerro I, McAvoy Corporation and Del Cerro II. The Notices of Deficiency disallowed the partnership losses in *Kahan* (Del Cerro I), *Thompson* (Del Cerro II), and *Berman* (Del Cerro II) on the primary grounds

that interest costs incurred and paid in connection with the Sunset transactions were not interest. The individual interest deduction claimed by *Ain* in the McAvoy Corporation transaction was denied on the grounds that the transaction was not interest.

The disallowances in *Ain, Thompson,* and *Berman* result in additions to basis for *Ain, Thompson,* and *Berman.* These additions to basis are deductible as a consequence of the business losses suffered by Del Cerro II in 1967.

STATEMENT OF THE FACTS

The foregoing facts were raised by the parties and known at the audit level by the Internal Revenue Service, at the United States Tax Court level, which was the trial court, and before the Ninth Circuit Court of Appeals. The basis adjustment arises with the adjustment by the auditor which was confirmed by the courts when sustaining the disallowances. It is the failure at each level to allow for and dispose of the increase in basis in 1967 that makes this case worthy of review by the United States Supreme Court.

BASIS FOR FEDERAL JURISDICTION

Federal jurisdiction existed in the United States Tax Court as the result of a timely filing by petitioners in that court within ninety days of the receipt of Notices of Deficiency. An appeal was thereafter timely taken to the Ninth Circuit Court of Appeals. This petition is timely under the Rules of this Court.

REASONS FOR GRANTING THE WRIT

Petitioners acknowledge that only exceptional circumstances will entitle them to have this petition granted. Petitioners do not claim that exceptional circumstances arise from the administrative adjustments disallowing particular items in the Notices of Deficiency, or from the Decision of the United States Tax Court, or the affirmation thereof by the appellate court.

The exceptional circumstances here arise with the failure of the Internal Revenue Service and the courts to complete the job at administrative, trial and appellate levels. At each level there has been a failure to follow through to completion the logical consequences of the Notices of Deficiency (at the audit level), the Decision (at the United States Tax Court level), and the Opinion (at the Ninth Circuit Court of Appeals level).

Where an administrative agency and/or a court makes a finding which disposes of one issue only to give rise to another issue, and such second issue is, as a consequence, before the administrative agency or the court, the failure to dispose of such second issue is a denial of due process.

The regulations of the Internal Revenue Service contemplate disposition of all issues arising in the course of an audit. The mitigation statutes contemplate protection both of the Internal Revenue Service and taxpayers where the adjustment in one year affects a closed year. On the face of matters, a trial court should dispose of all issues before it in any one proceeding or for any one tax year.

At the time of the audit adjustments in these cases, the auditor knew full well that the disallowances of *Ain* (1965),

and *Thompson* (1966) would increase the basis for those individuals in Del Cerro II in 1967. The auditor therefore should have reached some conclusion with regard to 1967 that would recognize the consequences of the 1965 and 1966 adjustments. This was not done. It is regrettably common that this is not done. The failure to do so results in frustration, expense and violation of the Regulations of the Internal Revenue Service.

The United States Tax Court with its conclusion in *Ain* and *Thompson* also had before it the necessary consequence that basis for these taxpayers was changed for 1967. The Tax Court could and should have then made appropriate findings for 1967. To fail to do so was to ignore the principle of judicial economy, force the taxpayers to make payment, apply for refunds, and ultimately renew litigation in the United States District Court for the year 1967. The same principles should have been applied at the Ninth Circuit Court level.

With reference to the year 1967, the disallowance in *Berman* results in an adjustment of basis in 1967 (the same year of the disallowance). Thus, in *Berman*, we have an independent due process question in that the taxpayers' situation is not resolved for the particular year in which adjustment is made when the adjustment produces consequences in that same year. The failure to conclude the adjustment in the one year must deny *Berman* due process.

This particular situation occurs again and again. It is not unique to *Ain*, *Thompson* or *Berman*. It is well known, and petitioners presume the Court can take judicial notice of the fact that partnership syndications involve thousands of

taxpayers in the United States every year. As a consequence, there are thousands of audits resulting in a volume of judicial proceedings before the United States Tax Court, the Court of Claims, and the United States District Court. For example, in the present situation, petitioners were part of a partnership in Del Cerro II (which involved approximately fifty partners). It is obvious what the burden is on taxpayers, the government, and the courts if these cases are required to be solved under the mitigation statutes and/or by payment and refund actions.

This is not a situation in which there is a conflict among the courts. We have a simple failure of the courts to deal with a pressing problem. Action by this Court to establish the rule intended by Congress must result in hundreds of cases being disposed of in the original audit or in the original judicial proceeding, with resultant due process for the taxpayer and judicial economy for the system. It seems so simple and obvious that it is a wonder that the matter has not long since been disposed of by enforcement by the Internal Revenue Service of its own regulations and/or in the trial and appellate courts below.

In our case, the years 1965 and 1966 involve the question of adjustments in basis after erroneous treatment of a prior transaction. This clearly comes within Section 1312(7) of the Internal Revenue Code. Erroneous treatment of transactions results in disallowance of deductions, and then an adjustment to basis follows. While for 1965 and 1966 it appears that Section 1313 contemplates a prior final decision in the course of litigation, it is certainly within the spirit and intendment of the mitigation statutes

generally that an issue arising in a single proceeding which is susceptible of disposition in that proceeding should not be required to await further subsequent litigation. Section 1314, in discussing the amount and method of adjustment, supports this view.

In *Berman* for the year 1967, the adjustment is not in a different year but is in the same year in which the basis change results from the adjustment. Whatever argument might be made for an adjustment in another year, i.e., 1965 and 1966 (as affecting a subsequent year and calling for the application of the mitigation statutes), it is clear that in *Berman* any possible justification for failing to act totally in that particular litigation must deprive *Berman* of due process.

With reference to the statute of limitations bar, petitioners represent to the Court that more than three years had elapsed at the time of the Tax Court litigation. This will appear from the face of the Tax Court decision and with the last tax year involved being 1967.

CONCLUSION

A taxpayer claims an interest deduction in the year 1965. It is disallowed in the course of audit. An adjustment to basis results. Such basis adjustment is of no significance in the year 1965 but is of significance in the year 1967. What is the appropriate procedure under the circumstances?

A taxpayer claims a partnership deduction in the year 1966. The partnership deduction is disallowed. An adjustment to basis results but has no consequence for the year

1966. It does have significance for the year 1967. What is the proper procedure under the circumstances?

A taxpayer claims a partnership deduction in the year 1967. The deduction as claimed is disallowed. An adjustment in basis results which is of significance in the same year (1967) because of other losses. What is the proper treatment of the items in the circumstances?

The answers to these questions affect large numbers of taxpayers at both administrative and judicial levels. The questions can be presented to the Court relatively briefly and economically. The Court has a unique opportunity to decide questions in this litigation whose answers will result in due process within the tax system and substantial reduction in litigation both independent of and related to the mitigation statutes. Petitioners believe that exceptional circumstances exist here.

Dated: March 13, 1981.

Respectfully submitted,

/s/ HARRY MARGOLIS
COUNSEL FOR PETITIONERS
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CERTIFICATE OF SERVICE

A copy of the foregoing Petition for Writ of Certiorari with accompanying appendices was mailed this date to

Attorney General of the United States
Department of Justice
Washington, D.C. 20530

and to

Solicitor General of the United States
Department of Justice
Washington, D.C. 20530

Dated: March 13, 1981.

/s/ HARRY MARGOLIS

APPENDICES

APPENDIX A

66 T. C. No. 91

UNITED STATES TAX COURT

AUDREY M. THOMPSON, ET AL.,[1]
Petitioners v. COMMISSIONER OF
INTERNAL REVENUE, Respondent

Docket Nos. 1164-70, 1330-70,
1336-70, 3015-70.

Filed September 21, 1976.

(1) Del Cerro Associates ("DCA"), a limited partnership, contracted to purchase certain land from Sunset International Petroleum Corporation ("Sunset") for $1,456,000, in promissory notes.

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[1] Cases of the following petitioners are consolidated herewith: Florence Ain and Gregory Ain, docket No. 1330-70; Dorothy E. Kahan and Robert Kahan, docket No. 1336-70; Nana Berman and William Berman, docket No. 3015-70. In addition, the parties in the following related cases have stipulated that the Court's decision in the four consolidated cases will be binding upon such parties with respect to the issues in such consolidated cases

At the closing of the purchase DCA paid Sunset $350,000 in cash, which was designated as prepaid interest for four years on the purchase-money notes. Shortly thereafter, DCA granted Lion, a real estate broker wholly owned by Sunset, an exclusive and non-cancellable right to improve and resell the property at a price of not less than $2,250,000.

Held: The cash paid by DCA at the time of purchase of the property represented prepaid interest and was not in substance a disguised loan to Sunset which was to have been repaid through resale of the property by Lion.

Footnote 1--continued

which are common to such related cases: Ruth Maietta and Salvatore Maietta, docket No. 1163-70; Marjorie Brock and Robert L. Brock, docket No. 1165-70; Sonia Morriss and Bentley Morriss, docket No. 1166-70; Zelda Kaplan and Victor E. Kaplan,

(?) In August 1965, Sunset sold certain land, for $700,000 in promissory notes, to McAvoy, a shell corporation, wholly owned by ABC, a Bahamian trust company. At the same time Sunset and McAvoy entered into a series of contracts for the development of the property by Sunset, and McAvoy paid Sunset $650,000 in cash, of which $280,000 was designated as prepaid interest on the purchase-money notes and $370,000 was designated as a prepaid financing fee. Within three months thereafter ABC sold 98.583 percent of its stock in McAvoy to a group of individual investors for an aggregate price of $6,800,000

Footnote 1--continued

docket No. 1167-70; Lee Edna Ford and John R. Ford, docket No. 1224-70; Leta N. Allee and Eddie L. Allee, docket No. 1329-70; Esther Carlin and Gene A. Carlin, docket No. 1331-70; Eugenie Magana and Raoul Magana, docket No. 1334-70; Margerie Goldberg and Jerome Goldberg, docket No.

in promissory notes. Such investors paid an aggregate of $475,000 in cash in 1965 as purported interest on the $6,800,000 in promissory notes.

In 1966 McAvoy was dissolved into DCA, and DCA took over the property and assumed the $6,800,000 in purported promissory notes of the former individual stockholders of McAvoy (who became partners of DCA). DCA also recorded on its books the unamortized balance ($245,000) of the interest prepaid by McAvoy to Sunset in 1965 and $6,254,500 as an intangible asset representing the purported value of McAvoy's rights and interests in

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Footnote 1--continued

1335-70; Norma M. Olney and Daniel C. Olney, docket No. 1337-70; Helen Weinstock and Ralph Weinstock, docket No. 1520-70; Mary Balaban and Leonard Balaban, docket No. 1521-70; Ruth Heldman and Morriss J. Heldman, docket No. 1522-70; Hope Corey

connection with the contracts with Sunset to develop the property. In its 1966 return DCA claimed deductions of $825,000 as interest paid in 1966 on the $6,800,000 of purported promissory notes and $245,000, representing a complete write-off of the aforementioned unamortized prepaid interest.

In 1967 Sunset encountered financial difficulties and defaulted on certain of its obligations relating to development of the property. DCA and Sunset entered into settlement agreements substantially relieving Sunset of these obligations.

Footnote 1--continued

and Jeff Corey, docket No. 1525-70; Elizabeth J. Lovin and Bailey J. Lovin, Jr., docket No. 1526-70; Barbara N. Shaw and Robert L.Shaw, docket No. 1527-70; Evelyn Lusher and Bernard Lusher, docket No. 1528-70; Kathryn A. Soares and Robert J. Soares, docket No. 1529-70; Margaret E. Kennedy and Leonard J. Kennedy, docket No. 1530-70; Alan G. Mack, docket No. 1531-70; Anita Robinson and Seymour

In its 1967 return DCA claimed a deduction for a complete write-off of the $6,254,500 intangible asset which it had recorded on its books in 1966 as the purported value of its rights and interests under the Sunset development contracts.

Held: (a) The series of transactions which resulted in the issuance of the $6,800,000 in promissory notes, which notes were later assumed by DCA, were not bona fide transactions and amounted to a sham. Accordingly, the promissory notes did not represent bona fide indebtedness, and the amounts paid as purported interest

Footnote 1--continued

Robinson, docket No. 1532-70; Eleanor S. DeMatoff and Seymour J. DeMatoff, docket No. 1656-70; Toby Roselinsky and Harold Roselinsky, docket No. 1657-70; Marlene J. Gurdin and Michael M. Gurdin, docket No. 1658-70; Suzanne Stewart and Robert Stewart, docket No. 1709-70; F. P. Fisher, docket No. 1735-70; Marie Levy and Mitchell Levy, docket No. 1755-70; Barbara Rafferty

with respect thereto in 1965 (by the individual investors) and in 1966 (by DCA) are not deductible as interest.

(b) The $245,000 of prepaid interest written off by DCA in 1966 does not

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Footnote 1--continued

and John H. Rafferty, docket No. 1759-70; Marjorie Sievers and Jerome J. Sievers, docket No. 1763-70; Rena Gettelman and Eugene Gettelman, docket No. 1766-70; Michael (Williams) Schwartz, docket No. 1781-70; Norman Pitt, Individually and as Executor of the Estate of Eleanor Pitt, Deceased, docket No. 1782-70; Elizabeth Harrington and Marvin Harrington, docket No. 1783-70; Bernice Dimitman and Merlin Dimitman, docket No. 1796-70; Annette Marcus and Philip M. Marcus, docket No. 1797-70; Mamie Joe and Walter Joe, docket No. 2843-70; Leah London and Milton London, docket No. 2844-70; Martha Shell and Albert Shell, docket No. 3014-70; Delores M. Lusk and Robert W. Lusk, docket No. 3332-70; Estate of Milton Rosenthal, Deceased, Elaine B. Fischel, Executrix, docket No. 4182-70; Ruth Ann Lewis and Sheldon P. Lewis, docket No. 4364-70; Melita Forsberg and Robert Forsberg, docket No. 4588-70; Marguerite A. Gilbert and William B. Gilbert, docket No. 4589-70; Jane M. Schmidt and Harry M. Schmidt, docket No. 4612-70; Marilyn M. Diekmann and Edward F. Diekmann, docket No. 4613-70.

give rise to a deduction for interest in that year since DCA, a cash basis taxpayer, did not actually pay such interest in 1966.

(c) DCA's 1967 write-off of $6,254,500 for loss of alleged contractual rights and interests is not deductible for tax purposes since such rights and interests had no tax basis.

Harry Margolis, for the petitioners.

Sheldon M. Sisson, for the respondent.

DAWSON, Chief Judge:* Respondent determined deficiencies in the income tax of petitioners in these consolidated cases as follows:

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* Pursuant to a notice of reassignment sent to counsel for the parties and to which no objections were filed, this case was reassigned from Judge Austin Hoyt to Judge Howard A. Dawson, Jr., for disposition.

Docket No.	Petitioners	Taxable Year 1965	1966	1967
1164-70	Audrey M. Thompson	$7,018.41	$4,725.00	-
1330-70	Florence Ain and Gregory Ain	1,334.28	1,507.20	-
1336-70	Dorothy E. Kahan and Robert Kahan	5,881.19	5,332.76	-
3015-70	Nana Berman and William Berman	3,394.51	3,481.40	$6,802.21

The four consolidated cases, as well as the related cases referred to in footnote 1, are all concerned with a series of transactions during the years 1965 through 1967, involving Del Cerro Associates (a limited partnership) and Douglas R. McAvoy Organization (a California corporation). All of the petitioners in these cases were either partners in Del Cerro Associates or stockholders of Douglas R. McAvoy Organization, or both, during the years in question. In order to facilitate trial, briefing and decision, the parties have designated each of the four consolidated cases, respectively, as representative of one of the four issues to be decided, and have stipulated that our disposition of the designated issues in each case will be binding in all of the related cases

involving such common issues.

The issues presented for decision are as follows:

(1) Kahan - Whether a payment of $350,000 by Del Cerro Associates to Sunset International Petroleum Corporation in 1965 represented deductible prepaid interest or was in substance a loan to Sunset.

(2) Ain - Whether amounts deducted by petitioners in 1965 as purported interest on personal promissory notes, given in payment for the purchase of stock, should be disallowed because the transactions giving rise to such notes were not bona fide.

(3) Thompson - Whether certain amounts paid by Del Cerro Associates in 1966 are properly deductible as interest.

(4) Berman - Whether Del Cerro

Associates is entitled to a deduction in its 1967 return for a write-off of a purported intangible asset designated as "Contractual Rights and Interests."

FINDINGS OF FACT

Dorothy E. Kahan and Robert Kahan
(Del Cerro Associates - 1965)

Most of the facts have been stipulated, and such stipulated facts are found accordingly. Petitioners are husband and wife, residing in Los Angeles, California. They filed their income tax returns for 1965 and 1966 with the district director of internal revenue in Los Angeles.

Robert Kahan is a certified public accountant, engaged in a public accounting practice with a partner, Seymour DeMatoff, in Los Angeles, California. This practice serves approximately 300 individuals and 100 legal entities. In addition, Kahan has a small specialized accounting practice which he has conducted for approximately 25 years. During such period Kahan also engaged in the organization and promotion

of various real estate and business ventures.

In 1965, Kahan began discussing various possible real estate transactions with Richard L. Weiss, Vice President of Sunset International Petroleum Corporation ("Sunset"). Sunset was a publicly owned corporation, headquartered in California, with more than 10,000 stockholders in 1965. Although it also engaged in the production of petroleum, its principal business activity during 1965 was real estate development. One of the major parcels of land held by Sunset was approximately 4,000 acres, located in San Diego, California, and known as Del Cerro. This property was being developed by Sunset for homes, shopping centers, gas stations, office buildings and a wide range of other improvements.

In the course of his discussions with Weiss, Kahan learned that Sunset was anxious to generate gains from real estate sales prior to the end of its fiscal year, August 31, 1965; however, it wanted to do so in a way in which it could retain a continuing interest in the future development of any undeveloped land sold. Any such gains would be offset for tax purposes by net operating loss carryforwards and deductions for depletion and intangible drilling costs relating to Sunset's petroleum business. Essentially, Sunset was seeking a way to generate sales and profits for financial reporting purposes, but to retain control over, and a financial interest in, the property sold. At the same time Kahan was seeking real estate investment and tax shelter opportunities

for various of his clients.

One of the parcels discussed by Weiss and Kahan was a 112-acre section (known as "Del Cerro Units 5 and 6") of Sunset's Del Cerro property in San Diego. Kahan spoke to several of his clients concerning the parcel, and on August 26, 1965, a partnership, known as Del Cerro Associates, was organized to acquire the 112-acre parcel (hereinafter referred to as "the San Diego property"). The partnership consisted of Kahan and 18 other individuals, 15 of whom were clients of Kahan. One of the general partners was Ben Margolis, a lawyer and a close personal friend of Kahan. On August 28, 1965, three days before the end of Sunset's fiscal year, a letter agreement was signed, providing for the conveyance

of the San Diego property.[2]

The agreement provided for the sale of the San Diego property by Sunset for a total price of $1,456,000, to be paid by the delivery of two promissory notes, one in the amount of $200,000 and the other in the amount of $1,256,000, both payable in full on September 1, 1978. Both notes were to provide for interest at the rate of 6 percent per annum, payable monthly. The $200,000 note was to be unsecured and the $1,256,000 note was to be secured by a second mortgage on the property being conveyed. The agreement also contained other material provisions, which may be summarized as follows:

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[2] The original letter agreement was between Sunset and North American Financial Corporation, a corporation managed by certain business affiliates of Kahan (in which none of the Del Cerro Associates

1. The buyer was given the option to prepay at closing the first four years' interest on the two notes, amounting to $349,440. If such option were elected, all interest accruing after the fourth year would be deferred and payable only upon maturity of the notes.

2. The property sold was subject to an existing first mortgage covering a large tract of land owned by Sunset, from which the subject parcel was carved out for sale. The portion of the blanket mortgage allocable to the 112 acres sold was $360,000. Sunset was specifically

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Footnote 2 continued

partners had any ownership interest); however, North American Financial Corporation had assigned all of its rights and obligations under the agreement to Del Cerro Associates prior to its execution. Since the temporary interposition of North American Financial Corporation as the original party to the Sunset agreement is not material to the issues in this case, the Sunset

granted the right to continue the first mortgage on the property (or to replace it with another first mortgage no greater than $360,000), until August 1, 1968. Sunset was obligated to make all payments with respect to, and to maintain free of default, any such first mortgage, and to pay in full any remaining balance on or before August 1, 1978, one month before the maturity date of the buyer's notes.

The transaction closed on August 31, 1965, at which time Kahan, acting for Del Cerro Associates, delivered to Sunset checks totaling $350,000, representing prepayment of four years' interest on the purchase money notes, in exercise of the

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Footnote 2 continued

agreement will hereinafter be treated as if it ran directly between Sunset and Del Cerro Associates.

interest prepayment option contained in the latter agreement, as described above.[3]

On September 28, 1965, Del Cerro Associates entered into an agency agreement with Lion Realty Corporation ("Lion"), a licensed real estate broker and a subsidiary of Sunset, in which Lion was appointed as its sole and exclusive agent with respect to the San Diego property. This agreement contained, inter alia, the following provisions:

> 3. Authority of Agent
>
> Lion shall have the full power and authority to do the following:
>
> 3.1 To improve the Property or cause the same to be improved and in connection therewith to pay for such improvements provided that the

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[3] The difference between the $350,000 paid and the $349,440 required, as specified in the agreement, is not explained in the record.

principal amount of such loans and advances shall not exceed One Million Dollars ($1,000,000.00) without the prior written approval of Del Cerro. The right of Lion to improve the Property shall be subject to the following:

3.1.1 Lion shall not cause the Property to be subdivided without the prior written consent of Del Cerro.

3.1.2 Lion shall be entitled to receive six per cent (6%) interest compounded annually on all funds advanced by Lion for the maintenance, improvement and development of the Property, which sums shall be paid either interest or principal from sale proceeds only and Del Cerro shall have no personal liability for any such items at any time and all Lion's rights to reimbursement shall cease upon the sale of the Property.

Footnote 3 continued

The purchase-money notes, totaling $1,456,000, delivered to Sunset at closing were executed by North American Financial Corporation ("North American"), see footnote 2, supra, and the deed of the property from Sunset was in favor of North American. However, the North American notes were guaranteed (in separate guarantee documents) by all of the Del Cerro Associates partners, and on September 30, 1965, the property was deeded over by North

3.2 Lion shall have the sole and exclusive right to sell the Property prior to the date of the termination of this agency at public sale. The right of Lion to sell the Property hereunder shall be subject to the following:

3.2.1 The Property shall all be sold as one unit.

3.2.2 The sale shall be only for cash.

3.2.3 The amount realized from such sale shall not be less than $2,250,000.00. Provided such minimum sum shall be paid to Del Cerro as the first distribution of sale proceeds, Del Cerro does hereby agree to deliver the Property to the purchaser free and clear. The remaining proceeds of such sale shall be divided as follows:

(a) To Lion, until Lion shall have received an amount equal to all funds advanced or caused to be advanced by it under this Agreement, with interest thereon as herein provided; plus commission in amount

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Footnote 3 continued

American to Del Cerro Associates. (The original North American notes were further guaranteed in favor of Sunset by North American's parent corporation, Universal

equal to twenty per cent (20%) of the gross sales price.

(b) All sums remaining shall be paid to Del Cerro.

3.2.4 Del Cerro shall execute any and all deeds and/or other documents that may be necessary to consummate the sale of the Property in accordance with this Article 3.

4. Consideration for Agency

As the consideration for the granting of the agency hereunder, Lion shall pay all taxes, assessments and charges of every kind on the Property from September 1, 1965, up to and including the date the Property is sold or this agency terminates so that Del Cerro shall not be required to advance any sums of any kind hereunder until the property is sold hereunder.

* * *

6. Lion Advances

No sum advanced by Lion shall be recoverable by Lion except through sale of the property hereunder and then only to the extent that such advances can be repaid

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Footnote 3 continued

Decoration Leasing Company, on September 30, 1965.)

from the sale price. Any deficiency shall be lost forever by Lion.

The agreement was terminable prior to sale of the property only by mutual agreement of the parties, default by Lion on any of its obligations, or Lion's bankruptcy, insolvency or assignment for the benefit of creditors. Neither party could assign its rights without the consent of the other. The agreement was eventually terminated by mutual agreement of the parties as of November 21, 1966.

Del Cerro Associates filed a partnership income tax return for the calendar year 1965, claiming a loss of $350,000. The loss was composed of:

1.	Prepaid interest on notes for $1,456,000	$349,450
2.	Other deductions (unidentified)	550
	Total	$350,000

The following table sets forth the names of the Del Cerro Associates partners as of December 31, 1965, and the capital contribution (and allocable share of the claimed partnership loss) of each partner:

Partner	Capital Contribution (Share of Loss)
Robert L. Brock	$ 15,000
Jeff Corey	25,000
Edward Diekmann	6,250
Robin Drews	5,000
Robert Forsberg	6,250
Eugene Gettelman	25,000
William Gilbert	6,250
Marvin Harrington	25,000
Robert Kahan	20,000
Victor Kaplan	25,000
Milton London	10,000
Salvatore Maietta	25,000
Margolis and McTernan	70,000
Bentley Morriss	25,000
Norman Pitt	15,000
Harry Schmidt	6,250
Jerome Sievers	25,000
Audrey Thompson	15,000
	$350,000

At least 11 of the partners listed provided their capital contributions with funds borrowed specifically for that

purpose.[4]

Respondent disallowed the partnership's claimed loss, and accordingly, disallowed the deductions claimed by the various partners, including petitioner Kahan, for their allocable shares of such loss.

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[4] At least four of the partners utilized personal funds. The source of the funds contributed by the remaining partners, who are not petitioners in these related cases is not determinable from the record.

Florence Ain and Gregory Ain
(Douglas R. McAvoy Organization-1965)

Most of the facts have been stipulated and such stipulated facts are found accordingly. Petitioners are husband and wife, residing in Hollywood, California. They filed their income tax returns for 1965 and 1966 with the district director of internal revenue, Los Angeles.

Harry Margolis is an attorney specializing in the field of taxation. He is the brother of Ben Margolis, one of the general partners of Del Cerro Associates. He has at various times acted for or dealt with, in a professional capacity, all of the petitioners in these related cases.

Dr. A.A.G. Smeets (a notary) and Dr. W.M.J. Alvares Correa (an attorney) were, during the years at issue herein, well-

known business and professional figures in the Netherlands Antilles. Together, they headed an organization (referred to hereinafter as the "Smeets-Correa organization") of numerous entities, some of which were engaged in the business of providing trustee and corporate management services to trusts and corporations established in the Netherlands Antilles and the Bahamas. Corporate management services were provided for a fee, and included all services necessary for the operation of a corporate business, including office or warehouse space, employees, accounting, administration and legal services. The Smeets-Correa organization was in 1960 believed to be the largest company-management organization of its type in the world, representing some 800 organizations, including more than 60

firms listed on the New York Stock Exchange. In addition, both Smeets and Correa have extensive personal financial interests in banking and other industrial and commercial enterprises.

During 1963 the Smeets-Correa organization formed a trust company in the Bahamas, known as Aruba Bonaire Curacao Trust Company Limited ("ABC"), which was beneficially owned (through another corporation) by Correa. Until the spring of 1965 ABC (which was not itself engaged in banking activities) was locally managed by, and shared office space in Nassau with, a Bahamian bank; it had no direct employees in Nassau. Subsequently, ABC acquired its own Nassau employees (six at time of trial) and office space (2400 square feet at time of trial); however, its principal officers and directors have

at all times been part of the Smeets-Correa organization and located in Curacao, Netherlands Antilles.

During 1963 Harry Margolis and/or associates of his represented approximately 16 clients in the establishment of trusts at several banks in the Bahamas. These 16 trusts were all eventually placed with ABC. Subsequent to 1963, additional trusts were established at ABC by clients of Harry Margolis, and at the time of trial herein, Harry Margolis represented over 150 such settlors. Several of the petitioners in these related cases have interests as settlor or beneficiary of such trusts; however, none of such petitioners has any ownership interest directly or indirectly in ABC.

On or about June 15, 1965, ABC

purchased, for $750, all of the outstanding stock of an inactive California corporation named Douglas R. McAvoy Organization (referred to hereinafter as "McAvoy"). McAvoy was acquired by ABC solely as a corporate shell for use in the transactions described below. During August, 1965, ABC contributed $650,000 in cash to the capital of McAvoy. The funds used by ABC for this purpose were obtained from a trust which did not involve any of the petitioners in these cases.[5]

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[5] It appears, although not entirely clear from the record, that ABC's involvement in these transactions was as a trustee or agent, and not for its own account.

On or about August 31, 1965, McAvoy entered into a series of agreements with Sunset concerning two commercial and multi-residential parcels of 11.9 and 8.25 acres, respectively, in a larger tract owned by Sunset, north of Los Angeles, known as Thousand Oaks. These agreements consisted essentially of the following:

AGREEMENT OF SALE - McAvoy agreed to purchase the two parcels from Sunset at a price of $700,000, subject to later adjustment to bring the price into line with property values as of July 1, 1967, as determined by independent appraisal. The purchase price was to be paid by a promissory note in the amount of $700,000, secured by a mortgage on the subject property, and payable in full on September 1, 1975. The note was to bear interest at

10 percent per annum. The first four years' interest, or $280,000, was to be paid in advance, upon closing, with interest after the fourth year to be accrued and paid upon maturity of the note. The property being sold was part of a larger tract which was subject to an existing first mortgage. The 11.9-acre commercial parcel could be released from such mortgage for $383,180 and the 8.25-acre multi-residential parcel could be realeased for $166,030.

AGREEMENT FOR IMPROVEMENT OF LAND - McAvoy, as the new owner of the Thousand Oaks property, contracted to retain Sunset to arrange financing for, and to construct "all site and structural improvements" necessary to develop a shopping center at a cost of not less than $2 million and apartment buildings (at least 140 units) at a cost of not less than $1

million. Construction was required to commence by July 1, 1967, and to be completed by June 30, 1970. Sunset was to prepare development plans to be submitted to McAvoy for approval. Sunset was to obtain all interim and permanent financing, for which it was to receive a fee from McAvoy in the amount of $370,000, payable in advance at the time of execution of the agreement. (McAvoy was responsible for all interest on financing arranged by Sunset.) Sunset was also to be paid a contractor's fee equal to 4 percent of all direct construction costs.

JOINT VENTURE AGREEMENT and INDENTURE OF LEASE - In these two separate but related documents, McAvoy and Sunset entered into a Joint Venture, which Joint Venture leased the Thousand Oaks property from McAvoy for the purpose of "operating

and managing" the property. As "rent" payable by the Joint Venture to McAvoy under the Indenture of Lease, the Joint Venture was obligated, for the ten-year term of the lease, to: (1) assume and pay all financing costs incurred by McAvoy; (2) make interest-free loans to McAvoy to the extent necessary to pay for improvements to the property (or to make principal payments on the financing of such improvements). The lease was a "net lease," in which the Joint Venture was to pay all "impositions, costs, insurance premiums, and expenses and obligations of every kind and nature" relating to the Thousand Oaks property.

The lease also granted the Joint Venture an "option" to purchase the leased property on or before August 1, 1975. The option price, payable in cash,

was $1,360,000, plus assumption or payment of then existing mortgages, if exercised during 1970 or 1971; $1,480,000, plus assumption or payment of then existing mortgages, if exercised during 1972 or 1973; $1,600,000, plus assumption or payment of then existing mortgages, if exercised during 1974 or thereafter.[6] In order to maintain this option, the Joint Venture was obligated to pay to McAvoy the sum of $30,000 semi-annually, beginning December 1, 1965. Failure to make any such payment would result in termination of the option. All such payments made would be applied against the option price in the event of exercise.

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[6] The Indenture of Lease does not set forth an exercise price for the period prior to 1970.

The Joint Venture Agreement provided for a term of ten years, ending September 1, 1975 (or upon resale of the property, if earlier). It also provided that the purchase option contained in the Indenture of Lease would be exercised by the Joint Venture (without specifying the exercise date), and that Sunset was required to provide all of the funds required to exercise the option, as well as to maintain the option until exercised ($30,000 semiannually). Sunset was also required to loan to the Joint Venture all moneys required to be paid as "rent" under the Lease, as described above, or required by the Joint Venture for any other purpose. Sunset was required to "bear all losses" and to recover any such losses only from profits. Sunset was granted broad exclusive power to "manage,

develop, improve, control, operate, maintain and sell" the Joint Venture's leasehold interest in the property. Any net cash receipts of the Joint Venture from operation or sale of the property would be applied first to repay all loans and advances made to the Joint Venture by Sunset (or by McAvoy, if any), and any remaining balance would be divided equally between Sunset and McAvoy.

The $280,000 "prepaid interest" referred to in the Agreement of Sale (and related purchase-money note), and the $370,000 fee for obtaining financing, referred to in the Agreement for Improvement of Land, were both paid by McAvoy to Sunset in cash at the time of closing of the above agreements on or about August 31, 1965. Both of these amounts were capitalized on the books of McAvoy,

which computed its income on the accrual method. The prepaid interest was amortized on a monthly basis, over a 4-year term; the prepaid financing fee was not amortized.

As security for Sunset's obligations and guaranties under the Joint Venture Agreement (including its obligation to provide funds to maintain and exercise the Joint Venture's option to purchase the property), the parties entered into a Pledge Agreement, dated September, 1965, whereby Sunset pledged to McAvoy all of the right, title and interest in the two promissory notes, totaling $1,456,000, which Sunset had received in connection with the sale of the San Diego property to Del Cerro Associates, as described in our Findings of Fact in Kahan, supra. As a further means of securing the rights of the parties, the title to the Thousand

Oaks property was deeded to a title company under the terms of a Holding Agreement, providing for the conveyance by the title company to the Joint Venture upon exercise of its purchase option or reconveyance of title to McAvoy should the option lapse.

In October and November of 1965, ABC, which then owned 100 percent of the outstanding stock of McAvoy, sold 98.583 percent of such stock to approximately 30 individuals (hereinafter sometimes referred to as "the McAvoy investors") at an aggregate sale price of $6,800,000.[7] Many of these individual investors were clients of Kahan and/or Harry Margolis,

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[7] The use of the words "sold", "sale" etc., in our Findings of Fact is for narrative convenience, following the form of the transactions, and is not intended as factual conclusions concerning the true nature of the transactions which are in question.

and entered the transaction on their advice. Each individual purchaser signed an unsecured promissory note in favor of ABC in the full amount of the purchase price for his portion of the stock acquired. All of such notes provided for interest at the rate of 10 percent per annum, with 10 percent interest "to be paid absolutely and in any event on or before December 31, 1965." No payments on principal were due until maturity, August 1, 1972.

On December 6, 1965, ABC assigned all of the notes of the McAvoy investors to World Minerals, N.V. ("World Minerals"), a Netherlands Antilles corporation.[8] On

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[8] No consideration was paid by World Minerals to ABC at the time of this assignment in 1965. Cash payments were made from World Minerals to ABC in subsequent years in connection with the assigned notes; however, the total amount paid is not determinable from the record.

or before December 31, 1965, the McAvoy investors paid a total of $475,000 to World Minerals, purportedly as interest on the aforementioned $6,800,000 of promissory notes.[9] The following table lists the names of each of the McAvoy investors and the amount paid (and deducted as interest) by each:

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[9] Although it appears that a total of $680,000 (10 percent of $6,800,000) was required to be paid by December 31, 1965, the parties have stipulated that a total of $475,000 was claimed as interest payments in 1965 by the McAvoy investors. The reason for the difference is not determinable from the record.

Investor	Amount Paid
John Ford	$15,000
Eddie Allee	10,000
Florence Ain	5,000
Jerome Goldberg	30,000
Ralph Weinstock	15,000
Leonard Balaban	10,000
Morris J. Heldman	5,000
Bailey J. Lovin, Jr.	10,000
Robert L. Shaw	20,000
Bernard Lusher	15,000
Robert Soares	20,000
Leonard Kennedy	40,000
Alan Mack	10,000
Seymour Robinson	15,000
Seymour DeMatoff	10,000
Harold Roselinsky	10,000
Michael Gurdin	40,000
Robert Stewart	20,000
F.P. Fisher	15,000
Mitchell Levy	25,000
John Rafferty	25,000
Michael Schwartz	10,000
Merlin Dimitman	10,000
Walter Joe	15,000
Albert Shell	15,000
William Berman	10,000
Robert Lusk	20,000
Milton Rosenthal	20,000
Sheldon Lewis	10,000

The deduction of the foregoing amounts as interest in the 1965 personal income tax returns of each of the taxpayers listed, including petitioner Ain, was disallowed by respondent, and it is this

disallowance which is at issue in the Ain case.

All but five of the above-listed investors made the indicated payments with funds borrowed for that purpose from Universal Decoration Leasing Company. Of the remaining five, four utilized personal funds and one borrowed the funds from Robert Kahan. Universal Decoration Leasing Company ("UDL") was a California corporation, incorporated July 1, 1964, all of the outstanding stock of which was owned by Associated Arts, N.V., a Netherlands Antilles corporation. None of the petitioners in any of these related cases had at any time any direct or indirect ownership interest of any kind in UDL of Associated Arts, N.V.[10]

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[10] The record is conspicuously silent as to the beneficial ownership and operating control of Associated Arts, N.V., except for a stipulation that World Minerals "at one time" owned 50 percent

Harry Margolis, at various times acted for or dealt with, in a professional capacity, both of these entities and served as counsel to UDL.

Audrey M. Thompson
(Del Cerro Associates - 1966)

Most of the facts have been stipulated and such stipulated facts are found accordingly. Petitioner resides in Hollywood, California. She filed income tax returns for 1965 and 1966 with the district director of internal revenue, Los Angeles.

During 1966, the interests of the original 18 Del Cerro Associates partners in the San Diego property and the interests of the 30 McAvoy investors in the Thousand Oaks property were combined into a single new partnership, which continued the name Del Cerro Associates

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of the stock of Associated Arts, N.V.

(sometimes referred to hereinafter as "Del Cerro 1966"). McAvoy was dissolved by Del Cerro 1966 and its 30 individual stockholders became partners of Del Cerro 1966;[11] its interest in the Thousand Oaks property and the several agreements relating thereto were transferred to the partnership.[12] In connection with this reorganization, the following facts are of significance in these cases:

(1) Six new investors, who had not previously been affiliated with either

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11 The disposition of the 1.417 percent of the McAvoy stock which was not sold by ABC to the McAvoy investors in 1965 (see our Findings of Fact in Ain, supra), is not determinable from the record.

12 Certain other assets of McAvoy were sold to unrelated parties.

Del Cerro Associates or McAvoy, became partners in the new combined partnership.

(2) Arrangements were made with World Minerals, the holder of an aggregate of $6,800,000 in promissory notes of the individual McAvoy investors (see our Findings of Fact in Ain, supra), for the cancellation of these individual notes and the assumption of the $6,800,000 aggregate obligation by Del Cerro 1966.

(3) The prepaid loan commitment fee in the amount of $370,000 and prepaid interest in the amount of $245,000 (net of amortization) which had been carried as assets (arising from the Sunset transactions described in Ain, supra) on the books of McAvoy prior to its liquidation, were carried forward

onto the books of Del Cerro 1966.

(4) The investment in the Thousand Oaks property, subject to the various contractual arrangements with Sunset, which was included in the assets of McAvoy at no more than $715,000 at the beginning of 1966,[13] was, in effect, written up on the books of Del Cerro 1966 by the introduction of a new asset described (in the Del Cerro 1966 partnership tax return for 1966) as "Contractual Rights and Interests" in the amount of $6,254,500.

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[13]The balance sheet for the beginning of 1966, contained in the 1966 final income tax return of McAvoy, reflects "Land" in the amount of $715,000. Although this figure is not broken down, it presumably includes the Thousand Oaks property, acquired in 1965 for $700,000, plus one or two other parcels owned by McAvoy at the time of its liqudations.

The 54 Del Cerro 1966 partners contributed an aggregate of $1,065,000 additional cash to the partnership in 1966. Most of these capital contributions were made with funds borrowed for that purpose from either Universal Decoration Leasing Company ("UDL"),[14] Anglo Dutch Capital Company, North American Financial Corporation or The Greater West Company.[15]

Anglo Dutch Capital Company ("Anglo Dutch") is a California corporation which is owned 50 percent by Harry Margolis and 50 percent by Walter Joe,

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[14] See our Findings of Fact in Ain, supra, for information concerning Universal Decoration Leasing Company.

[15] It has been stipulated by the parties that all loans from UDL, North American Financial Corporation and The Greater West Company were repaid with interest. Such stipulation is silent as to loans from Anglo Dutch Capital Company.

one of the Del Cerro Associates partners and a certified public accountant associated with Harry Margolis professionally. Several of the petitioners, including Walter Joe, have borrowed money from Anglo Dutch from time to time, although none, other than Walter Joe, has any direct or indirect ownership interest in Anglo Dutch.

North American Financial Corporation ("NAFCO") is a California corporation, which was inactive until acquired by UDL as a wholly owned subsidiary on July 1, 1964. NAFCO was then activated to engage in the loan servicing a real estate business. None of the petitioners in these consolidated cases had at any time any direct or indirect ownership interest in NAFCO. However, there was a close working relationship between Harry Margolis in a professional capacity,

NAFCO and UDL.

The Greater West Company ("Greater West") was a California corporation, actively engaged in real estate development until it was dissolved in 1967. It was wholly owned by T. C. McMillan until sold by him to ABC on December 15, 1965 in a transaction involving the McMillan family trusts. On December 13, 1966, ABC loaned Greater West $400,000. None of the petitioners in these consolidated cases had at any time any direct or indirect ownership interest in Greater West. However, Harry Margolis has at various times acted for or dealt with Greater West in a professional capacity.

In its partnership tax return for 1966, Del Cerro 1966 claimed an interest deduction in the total amount of $1,070,000. This amount consisted of

(1) $825,000 paid to World Minerals as interest (some portion being a prepayment) on the $6,800,000 obligation assumed from the former McAvoy investors, and (2) $245,000 representing a complete write-off of the prepaid interest account taken over by Del Cerro 1966 from the books of McAvoy at the time of the liquidation of McAvoy into the partnership. The partnership reported a net loss of $1,071,635.08 for 1966. This consisted principally of the aforementioned interest deductions, plus miscellaneous other deductions (in excess of a small amount of rent income). The following table sets forth the name, 1966 capital contributions, and allocable share of partnership net loss of each of the partners of Del Cerro 1966, as reported in its tax return. The table also identifies the several

partners whose capital contributions were provided through loans from the entities discussed above:

Partners	Contributions	Source of Funds for Contributions	Loss
Margolis & McTernan	$ 70,000		$ 70,427.86
Ain	5,000	Greater West	5,025.97
Allee	10,000	UDL	10,062.65
Olney	37,500		37,742.98
Balaban	15,000	Anglo Dutch	15,088.62
Berman	10,000	UDL	10,062.65
Brock	15,000	NAFCO	15,088.62
Carlin	30,000		30,187.97
Corey	10,000	UDL	10,062.65
DeMatoff	10,000	Greater West	10,062.65
Diekmann	6,250		6,290.50
Dimitman	15,000		15,088.62
Drews*	5,000		5,025.97
Fisher	25,000	Anglo Dutch	25,161.99
Ford	15,000		15,088.62
Forsberg	6,250		6,290.50
Gettelman	0		0
Gilbert	6,250		6,290.50
Goldberg	20,000	Anglo Dutch	20,125.31
Gurdin	30,000	Anglo Dutch	30,187.97

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Harrington	35,000	Greater West	35,213.93
Heldman	5,000	Greater West	5,025.97
Joe	15,000	Greater West	15,088.62
Kahan	20,000		20,125.31
Kaplan	30,000		30,187.97
Kennedy	40,000	Greater West	40,250.61
Levy	40,000	Greater West	40,250.61
Lewis	10,000		10,062.65
London	20,000		20,125.31
Lovin	10,000	Greater West	10,062.65
Lusher	15,000	Anglo Dutch	15,088.62
Lusk	20,000	Greater West	20,125.31
Mack	10,000	Greater West	10,062.65
Magana	52,500		52,831.61
Maietta	25,000	UDL	25,161.99
Marcus	25,000		25,161.99
Martin*	20,000		20,125.31
Morris	25,000	Anglo Dutch	25,161.99
Pitt	15,000	Anglo Dutch	15,088.62
Rafferty	25,000	Greater West	25,161.99
Robinson	15,000	NAFCO	15,088.62
Roselinsky	10,000	Greater West	10,062.65
Rosenthal	20,000	UDL	20,125.31
Rowan*	20,000		20,125.31

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Schmidt	6,250		6,290.50
Schwartz	10,000	Greater West	10,062.65
Shaw	20,000		20,125.31
Shell	15,000	UDL	15,088.62
Sievers	30,000	Greater West	30,187.97
Soares	20,000		20,125.31
Stewart	25,000	Greater West	25,161.99
Thies*	45,000		45,287.23
Thompsen	15,000	Greater West	15,088.62
Weinstock	15,000	NAFCO	15,080.62
	$1,065,000		$1,071,635.03

*Indicates partners who are not petitioners in these cases

[End]

The total net partnership loss was allocated among the partners in proportion to the 1966 cash capital contributions of the partners, without regard to the relative values of the San Diego property, contributed by the original Del Cerro Associates partners, and the Thousand Oaks property, contributed by the original McAvoy investors.

In her individual income tax return for 1966, petitioner deducted $15,000 as her share of the loss of Del Cerro 1966 (limited by the amount of her 1966 cash capital contribution). Respondent disallowed the partnership's claimed loss, and accordingly, disallowed the deductions claimed by the various partners, including petitioner, for their respective shares of such loss.

Nana Berman and William Berman
(Del Cerro Associates - 1967)

Most of the facts have been stipulated and such stipulated facts are found accordingly. Petitioners are husband

and wife, residing in Hillsborough, California. They filed their 1965, 1966 and 1967 income tax returns with the district director of internal revenue, San Francisco.

Del Cerro 1966, as referred to in the foregoing Findings of Fact, continued as the same partnership entity in 1967. For convenience of reference, our Findings of Fact and discussion concerning activities and events subsequent to 1966 will refer to the Partnership as Del Cerro.

During 1967 Sunset was experiencing serious financial difficulties, and began negotiations with numerous creditors, including several major financial institutions, as well as Del Cerro. Sunset was in default under its agreements with Del Cerro concerning Sunset's development of the Thousand Oaks property (i.e., the

Agreement for Improvement of Land, Joint Venture Agreement and Indenture of Lease, described in our Findings of Fact in Ain, supra). After several months of negotiations the arrangements between Sunset and Del Cerro were revised by two separate but inter-related agreements, dated December 8, 1967 and December 15, 1967, respectively. The net effect of these agreements may be summarized as follows:

(1) The purchase-money notes due from Del Cerro to Sunset with respect to the San Diego property ($1,256,000 and $200,000) and the Thousand Oaks property ($700,000) remained in effect, but without "personal" liability (i.e., should Del Cerro fail to make payment, Sunset's only recourse would be to foreclose and retake the respective properties; it could

not otherwise enforce payment of the notes). The two notes, totaling $1,456,000, held by Sunset in connection with the San Diego property remained pledged to Del Cerro as collateral for performance by Sunset of its obligations concerning the repurchase options under the Thousand Oaks agreements (see paragraph (3) below).

(2) Sunset was required to pay to Del Cerro $1,200,000 in cash on or before January 15, 1968, or alternatively, at the option of Sunset, to deliver to Del Cerro, on or before March 1, 1968, 110,000 shares of common stock of Commonwealth United Corporation ("CUC"), a public company which, at that time, was planning to merge with Sunset. In the event that Sunset should elect to deliver the CUC shares, it would, in effect, guarantee

that the average market price of such shares from March 15 to September 30, 1968, would not be less than $12 per share. (A mechanism was provided for the delivery of additional shares, or cash, subsequent to September 30, 1968, in the event that such average market price fell below $12 per share.)

(3) All other obligations of the parties to each other in connection with both the San Diego property and the Thousand Oaks property were canceled, except that in the event that Sunset should fail to entirely perform its obligations described in (2) above, it would technically continue to be obligated (but without "personal" liability) to continue to make the $30,000 semiannual option payments under the original Indenture of Lease and Joint Venture agreements

in connection with the Thousand Oaks property (and eventually to exercise the option to repurchase the property for the Joint Venture). Since this obligation would continue without "personal" liability, the only remedy available to Del Cerro would be to foreclose on the collateral securing Sunset's obligation, i.e., the notes totaling $1,456,000 in connection with the San Diego property. The net effect of these arrangements was that the $1,456,000 of notes from Del Cerro to Sunset, in effect, became collateral for Sunset's performance of its obligations, as described in (2) above, under the settlement agreements. Should Sunset fail to perform (and fail to make the Thousand Oaks option payments), then Del Cerro would be entitled to reclaim and cancel its $1,456,000 in notes payable to

Sunset, and thus, would end up with the San Diego property without further obligation to Sunset.

As of December 29, 1967, Del Cerro entered into an agreement with World Minerals, modifying the $6,800,000 obligation of Del Cerro to World Minerals, which Del Cerro 1966 had assumed from the original McAvoy investors (see our Findings of Fact in Thompson, supra). The principal provisions of this agreement may be summarized as follows:

(1) Del Cerro was relieved of all obligations to pay interest on the indebtedness from and after January 1, 1967, provided that the principal amount would be paid in full no later than December 31, 1970.

(2) The consideration which Del Cerro was to receive from Sunset in early 1968

under the settlement agreements summarized above (either $1,200,000 in cash or 110,000 shares of CUC stock, at the option of Sunset) was to be paid over, immediately upon receipt by Del Cerro, to World Minerals and applied against Del Cerro's indebtedness. In the event that the 110,000 shares of CUC stock was delivered, it was to be credited at a value of $1,320,000.

(3) Del Cerro was to immediately transfer to World Minerals its interest in the San Diego property, subject to the purchase-money indebtedness of $1,456,000. The property was assigned a gross value of $2,250,000,[16] resulting in a net value, after related indebtedness, of $794,000, which amount was to be credited against

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16 This amount coincides with the agreed resale price established in the Lion agreement described in our Findings of Fact in Kahan, supra.

Del Cerro's $6,800,000 balance due to World Minerals.

(4) Del Cerro assigned to World Minerals its interest in an asset referred to as the "St. Martins Hotel Loan" at an agreed value of $50,000, to be credited against the $6,800,000 indebtedness.

(5) Del Cerro was given the right until December 1, 1968, to assign to World Minerals any or all of its remaining assets for credit against the balance of Del Cerro's indebtedness. Any such assigned assets were to be valued "at a price to be agreed upon between the parties or at a price determined by arbitration should agreement not be reached by the parties," but not less than "the book value of such items after straight line depreciation."

During 1967 all but six of the 54

Del Cerro partners contributed additional amounts to the capital of the partnership. Such contributions ranged in amount from $5,000 to $125,000, and totaled $1,178,317. Thirty-five of the partners made their contributions utilizing funds borrowed for that purpose. In its partnership income tax return for 1967, Del Cerro reported a net loss of $4,543,035, computed as follows:

Income realized on receipt of CUC stock		$1,200,000
Option income realized		120,000
Gain on sale of San Diego property to World Minerals		794,000
Gain on sale of St. Martins property to World Minerals		25,000
Rental income realized		10,493
		$2,149,493
Less: Write-off of intangible assets	$6,254,500	
Write-off of loan commitment fee	370,000	

Loss on Fresno property	24,781	6,649,281
Gross profit(loss)		($4,499,788)
Less: Other deductions (net of other income)		43,247
Net loss		($4,543,035)

Petitioner William Berman contributed $20,000 to the capital of Del Cerro in 1967. His allocated share of the partnership's net loss, as reported in the partnership's 1967 return, was $42,250.[17] Berman claimed a partnership loss of $19,937.35 from the Del Cerro partnership in his 1967 joint personal return and an additional $62.65 in his

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17 The allocation of the aggregate 1967 partnership net loss among the 54 partners appears to bear no relationship to either the relative capital accounts or the relative 1967 contributions of the partners. The method of allocation is not determinable from the record.

petition herein. This loss was disallowed in its entirety by respondent.

OPINION

Kahan

There is virtually no dispute as to the facts in this case. Almost all of the facts were stipulated, and most of the significant elements in analyzing the transactions in question are to be found in the stipulated documents. On their face the documents indicate a purchase of land by the Del Cerro Associates partnership for notes, with no cash downpayment, and a prepayment of four years' interest on the notes.[18] Respondent has

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18 Since the transaction in question took place in 1965, it is not subject to the provisions of Rev. Rul. 68-643, 1968-2 C.B. 76, which requires an allocation of the deduction for prepaid interest over the years involved. This ruling has no retroactive effect as to prepayments for periods not in excess of five years made prior to November 26, 1968.

challenged the claimed prepaid interest, which had been deducted in full in the partnership's 1965 Federal income tax return.

Respondent takes the position that, although the payment by Del Cerro Associates of $349,450 to Sunset was in the form of prepaid interest on a debt of $1,456,000, the transaction was in substance a loan of $349,450.[19] Cf. United National Corporation, 33 B.T.A. 790 (1935).

While we agree with respondent that the transaction contains several elements

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19 In the statutory notice, respondent characterized the payment by the partnership as a "nondeductible capital investment." It is not clear what this characterization was intended to mean, since the only position taken by respondent at trial and on brief was that the substance of the transaction was a loan.

tending to indicate that its substance was other than its form, petitioners, through the stipulated facts and relevant documents, have made a prima facie case based upon the form of the transaction, and it is not clear from the record that there was, in economic substance, a loan here.

The letter agreement of August 28, 1965, is a rather straightforward contract of sale. Del Cerro Associates actually took title to the property, Sunset received valid, enforceable promissory notes for $1,456,000 (secured by a mortgage on the property, except as to $200,000, which was unsecured), and Del Cerro Associates actually paid Sunset $350,000 in cash. These clear indicia of an unconditional sale are, however, significantly beclouded when viewed together with the September 28, 1965

agreement between Del Cerro Associates and Lion. While this agreement purports to be merely an agency contract, appointing Lion as agent for sale of the property for Del Cerro Associates, a careful reading of its terms indicates that it is in substance an artfully disguised option to Sunset (through Lion, its wholly owned subsidiary) to reacquire the property from Del Cerro Associates.

The Lion agreement was certainly unorthodox as a real estate brokerage contract. Lion was given rights to improve the property and the "sole and exclusive right to sell" the property at a minimum price of $2,250,000. This exclusive agency was for an indefinite period and was essentially not terminable by the property owner without the consent of the agent. Lion was to pay all taxes

and other carrying costs on the property prior to its sale. (Under the original letter agreement of sale, Sunset was required to service the existing first mortgage debt.) Del Cerro Associates was obligated to accept the minimum selling price of $2,250,000, and upon receipt of such amount, "to deliver the Property to the purchaser free and clear." This combination of rights and obligations is tantamount to an option in Lion to repurchase the property for $2,250,000.

Respondent contends that at the time that Del Cerro Associates acquired the San Diego property for $1,456,000 it was contemplated by both buyer and seller (Sunset) that the property would be reacquired by Sunset (through the mechanism of the Lion agreement) at a later date and at a higher price ($2,250,000), the higher

price being in compensation for the use of the money received by Sunset, purportedly as prepaid interest, during the period that Del Cerro Associates held title. Thus, he asserts, the contractual arrangements, viewed as a whole, amounted to a loan by Del Cerro Associates of the amount of cash which it paid to Sunset, purportedly as interest. The net return which could have been expected by Del Cerro Associates from this cash investment was, respondent contends, limited to a maximum amount, which in relation to the amount invested, was equivalent to interest. Respondent computes the amount as follows:

Anticipated resale price		$2,250,000
Less:	First mortgage to be paid off by Del Cerro Associates	(360,000)
Payoff of original purchase-money notes to Sunset		(1,456,000)
Net cash proceeds from resale		434,000
Less:	Original cash investment by Del Cerro Associates	350,000
Net cash gain		$ 84,000

The net gain is equivalent to 24 percent of the $350,000 cash invested at the outset by Del Cerro Associates. Respondent asserts that the expected time frame for "resale" of the property was four years (based upon the interest prepayment period), and, thus, the $84,000 net gain would amount to a return of six percent per year simple interest over the four-year period. Since most of the Del Cerro Associates partners had borrowed the

money which they invested, the economic gain (other than the income tax benefits) to these partners would be zero, with the income merely offsetting the cost of borrowing the money which was invested.[20] Meanwhile, all of the parties will have realized a substantial income tax benefit through the deduction of nearly $350,000 by the partnership as prepaid interest in 1965.

While we find respondent's analysis is quite persuasive, it contains a number of gaps which prevent us from being able to conclude with sufficient assurance that the substance of the transaction was as

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[20] Respondent appears to assume that the rate of interest on the borrowings of the partners was six percent per annum, although this cannot be determined from the record.

respondent contends. While we are convinced that the Lion agreement constituted an option to Sunset to repurchase the property, it did not require Sunset to repurchase. This fact seriously undermines the theory that the cash paid to Sunset was a loan to be repaid at the time of Sunset's "repurchase"; there was simply no binding obligation to repay the "loan" (i.e. to "repurchase" the property). See Irving Fisher, 30 B.T.A. 433, 440 (1934). Thus, for example, Sunset could have decided not to repurchase the property and could have decided not to repurchase the property and could have abandoned the Lion agreement by merely causing Lion to discontinue paying the real estate taxes and other carrying costs on the property. In such an event Del Cerro Associates would have exclusive control over the

property and bear all of the risks of ownership. Not only would it not be entitled to any repayment from Sunset, but it would still be obligated to ultimately pay its original notes to Sunset, with interest accrued after the fourth year.

Respondent appears to presume that it was a foregone conclusion that Sunset was bound to repurchase the property. Although neither the August 28, 1965 letter agreement with Sunset nor the September 28 "agency" agreement with Lion requires either Sunset or Lion to repurchase the property, it is possible that such a repurchase could have been assured by a separate side agreement (formal or informal) or by the possible fact that the original selling price to Del Cerro Associates and Sunset's $2,250,000 repurchase option price were

so far below the market value of the property that, as a practical matter, Sunset was bound to exercise its option, in order to preserve for itself the excess market value. But cf. Irving Fisher, supra, at 441. However, neither of these possible conditions is discernible from the record, and thus there is no basis for concluding that Sunset was bound to repurchase the property.

Although Sunset may not have been required to repurchase the property, the existence of the "option" to repurchase at a fixed price of $2,250,000 placed an effective ceiling on the potential return available to Del Cerro Associates on its investment. Such a ceiling is inconsistent with the unlimited potential gain or loss normally attendant upon an equity investment, and it tends to make the economics

of the transaction for Del Cerro Associates more like that of a secured debt investment. It is difficult to believe that anyone in the position of a true beneficial owner, seeking to maximize potential gain, would enter into an agreement such as the Lion agreement.

In spite of the foregoing, however, Del Cerro Associates' position does involve some of the characteristics of an equity investment. Respondent computes the maximum potential gain to Del Cerro Associates as $84,000 (in the table above) and asserts that this represents no more than a six percent annual return over four years. However, the exact time at which the property would be repurchased after one year, for example, the $84,000 gain would represent a 24 percent annual rate of return,

considerably more that would be expected by a lender. If the property were not repurchased until after four years, the rate of return would have been considerably less than six percent per annum. And, of course, if the property were not repurchased at all, which was a possibility, Del Cerro Associates would end up with all of the risks and rewards of equity ownership. See, e.g., United States v. Title Guarantee & Trust Co., 133 F.2d 990, 993 (6th Cir. 1943).

Petitioners, who bear the burden of proof, have, through the stipulated facts and documents embodying the transaction, made a prima facie case in support of their characterization and tax reporting of the transaction. Since we are unable to conclude with sufficient assurance that the transaction in question was in

substance a loan, as respondent contends, petitioner's deduction for prepaid interest in accordance with the formal structure of the transaction must be sustained.[21] Accord, Resthaven Memorial Cemetery, Inc., 43 B.T.A. 683 (1941).

Ain

Respondent characterizes the series of transactions involved in Ain as, in substance, a loan of $475,000 from the McAvoy investors (through a series of intermediate entities) to Sunset. Relying heavily on the formal elements of the transactions, which are reflected in the many stipulated documents, petitioners

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[21] Respondent has not challenged the deduction of the prepaid interest as a distortion of income under sec. 446, I.R.C., as amended. See n. 18, supra, and compare Andrew A. Sandor, 62 T.C. 456, affd. 536 F.2d 874 (9th Cir. 1976).

vigorously refute respondent's characterization. Here, as in Kahan, we must scrutinize the substance of the transactions in determining appropriate tax consequences.

Respondent's position, although not as fully developed on brief as it might have been, appears essentially as follows: Sunset desired to raise cash and generate sales of land before August 31, 1965, but to maintain control over, and an indirect interest in, any property sold solely to meet these short-term needs. The Thousand Oaks property was worth approximately $700,000. A transaction was negotiated in which the property was to be "sold" for $700,000 in promissory notes, but with Sunset receiving $650,000 in cash in the form of prepaid interest ($280,000) and a financing fee ($370,000). At the same time, however, Sunset committed

itself to provide all funds for development of the property, and to ultimately repurchase the property for the joint venture at not less than $1,360,000. The end result of this series of steps would be that Sunset would have had the use of the $650,000 in cash (less the $30,000 semiannual payments to maintain the repurchase "option") until such time as it would have "repurchased" the property at $1,360,000 by repaying $660,000 in cash and canceling the original $700,000 purchase-money mortgage receivable.

Although couched in the form of a sale and repurchase of property, the substance of the transaction does appear to be a loan, as respondent contends, particularly in light of the fact that Sunset was obligated to repurchase the property (at a price which would return the

$650,000 cash originally received by Sunset, plus an extra $10,000), and Sunset, therefore, continued to bear the risks and rewards of ownership. See United National Corporation, supra.

Petitioners make much of the fact that the $475,000 which was paid (and deducted on their individual tax returns) in 1965 by the McAvoy investors was not part of the $650,000 received by Sunset, but rather was paid as interest to World Minerals (assignee of ABC) in an entirely different transaction: the purchase of the McAvoy stock from ABC for $6,800,000 in personal notes. Therefore, petitioners contend, the McAvoy investors could not possibly be considered to have made a loan to Sunset. Respondent contends that, despite the elaborate network of entities and transactions, in ultimate substance

the money paid by the McAvoy investors (most of which was in turn borrowed for that purpose) was the source of the money received by Sunset. Respondent attempts, although with considerable difficulty, to trace the flow of funds from UDL through the McAvoy investors, World Minerals, and ABC, to Sunset.

Although respondent's thesis is quite persuasive, the record, despite voluminous stipulations of fact, is not clear on the matter. However, we do not consider it necessary to closely scrutinize the alleged flow of funds and to determine whether or not the transaction was in substance a loan to Sunset. Whether or not the $475,000 paid in 1965 by the McAvoy investors is characterized as such a loan, we hold that such payment does not qualify as tax-deductible

interest because the purported resale of the McAvoy stock by ABC for $6,800,000 in notes (with respect to which the claimed interest was paid) was not a bona fide sale, but was a sham transaction which cannot be recognized for tax purposes. Knetsch v. United States, 364 U.S. 361 (1960).

In 1965, all of the stock of McAvoy, then a corporate shell, was acquired by ABC for $750. ABC subsequently contributed an additional $650,000 to the capital of McAvoy, for a total investment of $650,750. In late August, 1965, the Thousand Oaks property was sold by Sunset to McAvoy for $700,000 in the form of a purchase-money mortgage. McAvoy paid Sunset an additional $280,000 in prepaid interest and $370,000 as a financing fee, which amounts were capitalized. Thus,

McAvoy held assets with a book cost of $1,350,000, subject to a long-term mortgage of $700,000. Within three months after these transactions with Sunset, ABC resold 98.583 percent of its McAvoy stock to the 30 McAvoy investors for $6,800,000, more than ten times its cash investment in such stock and more than ten times the stock's book value. Under the circumstances, the bona fides of such an arrangement are suspect on their face; a purchase and resale within three months at a tenfold increase in price strains reasonable credulity. Cf. Norman Titcher, 57 T.C. 315 at 322 (1971).

Petitioners contend that the $6,800,000 price at which the stock was resold to the McAvoy investors by ABC was not unrealistic. They acknowledge that the Thousand Oaks property itself had a fair market

value of only $700,000 but they contend that the execution by McAvoy of the related agreements with Sunset for the development of the property (i.e., the Agreement for Improvement of Land, Joint Venture Agreement and Indenture of Lease) caused an immediate dramatic increase in the value of the property as a multi-million dollar development project. Kahan testified that the McAvoy investors expected to realize a profit in the area of $10 million at the end of a 10 to 12 year period, through the development of the property under the arrangements with Sunset. We fail to see much justification for the McAvoy investors to have paid anything more than $700,000, let alone nearly ten times that much.

At the time that the development arrangements with Sunset were entered

into, Sunset's ability to fully perform must have been at least questionable, due to its financial difficulties. This is borne out by the fact that Sunset eventually went into bankruptcy without ever having performed. Moreover, the development arrangements with Sunset were an integral part of the transaction in which McAvoy purchased the land, although reflected in separate documents all dated August 31, 1965. Thus, whatever value may have been added to the property by the development arrangements existed at the time of McAvoy's purchase for $700,000, and it cannot be said that the alleged tenfold increase in value was created between that time and the time of subsequent resale to the McAvoy investors.

The McAvoy investors, or at least a

portion of them, were clients of Kahan and/or Harry Margolis. Kahan and Margolis were familiar with Sunset's 1965 year-end efforts to "syndicate" some of its properties and were familiar with the Thousand Oaks property in particular. Why then did not the McAvoy investors acquire the Thousand Oaks property directly from Sunset for $700,000, rather than acquire it (through the McAvoy stock purchased from ABC) for $6,800,000, less than three months later? It is inconceivable that Kahan or Margolis would have advised their clients to purchase, in a bona fide transaction, property for $6,800,000, which could have been acquired less than three months earlier for approximately one-tenth of that amount. Our doubts about the bona fides of such a transaction are reinforced by the relationship of

Harry Margolis and ABC, the initial purchaser (through McAvoy) of the property from Sunset. ABC was a small Bahamian trust company in business as a professional trustee, which until mid-1965, did not even have an office of its own. Although the acquisition, funding and resale of McAvoy were done in the name of ABC, the funds were obtained by ABC from a trust, and it is doubtful that ABC was acting for its own beneficial interest. The party(s) of beneficial interest are not determinable from the record. This gives rise to the suspicion that the funds may have been provided by a trust which had been established at ABC by one or more clients of Harry Margolis, who had been doing business with ABC (establishing trusts for clients) since 1963. In any event the connectionbetween Harry Margolis

and the McAvoy investors on the one hand and Harry Margolis and ABC on the other, leads to the impression that in planning the Thousand Oaks transactions with Sunset, ABC may have been intentionally interpositioned between Sunset and the McAvoy investors for the purpose of altering the appearance of the transaction in order to artificially create income tax deductions.

In this connection, we think it is more than coincidence that the $680,000 which was to be paid by the McAvoy investors in 1965 in the form of interest (at 10 percent on the aggregate alleged indebtedness of $6,800,000) exceeded by only $30,000 the cash received by Sunset in the Thousand Oaks transaction in 1965. Thus, instead of the McAvoy investors dealing directly with Sunset, the

transaction was structured with ABC as an intermediate entity, reselling the property to the McAvoy investors at a price having no relation to market value, but fixed at such a level that the $680,000 to be paid by the McAvoy investors in 1965 (and, presumably, in years thereafter) could be labeled as tax-deductible interest on such amount.

A similar situation arose in Martin M. Melcher, a memorandum opinion of this Court.[22] In that case the taxpayers sought to purchase a home which was available for $89,250. Instead of the taxpayers' purchasing the property directly for that price, the property was purchased

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22 T.C. Memo 1970-237 (1970), affd. without discussion of this point, 476 F.2d 398 (9th Cir., 1973).

by a corporation controlled by the taxpayers and their attorney, and thereupon "resold" by such corporation to the taxpayers for $110,000, with a $30,000 downpayment and a 15-year note for $80,000. In addition to the $30,000 downpayment, the taxpayers paid $76,000 as "prepaid interest" for the full 15-year period. We held that the purported purchase by the corporation and its alleged "resale" to the taxpayers was a sham, and that, therefore, the purported purchase money note was not a real and bona fide indebtedness, and no interest deduction was allowable for tax purposes. The same rationale applies in the instant case.

Although the relationship between the $650,000 received by Sunset and the $680,000 to be paid by the McAvoy investors to World Minerals (of which $425,000

was paid and is at issue herein) is not clearly discernible from the record, in circumstances such as those recited above, where the surrounding facts so clearly give rise to the inference that the purported purchase and "resale" by ABC were not bona fide transactions, it is incumbent upon the petitioners, who bear the burden of proof herein, to establish otherwise. They have not done so, and, accordingly, we hold that the payments at issue herein are not deductible as interest for tax purposes. Knetsch v. United States, supra; James A. Collins, 54 T.C. 1656 (1970); Norman Titcher, supra at 325.

Thompson

The issues for decision in the Thompson case derive from interest deductions claimed in the 1966 tax return of

Del Cerro 1966. The items of interest so claimed were (1) $825,000 paid to World Minerals as interest on the $6,800,000 "indebtedness" assumed by Del Cerro 1966 from the former McAvoy investors, and (2) $245,000, representing a complete write-off of the prepaid interest account taken over by Del Cerro 1966 from the books of McAvoy at the time of liquidation of McAvoy into Del Cerro 1966.

Our holding in Ain, supra, that the $6,800,000 of alleged indebtedness of the McAvoy investors was a sham and could not be recognized as bona fide indebtedness with respect to which tax deductible interest could be allowed, is also controlling in Thompson. Although the $6,800,000 of "indebtedness" upon which the $825,000 of interest was claimed in 1966 was no longer that of the 30 McAvoy investors individu-

ally, but had been assumed in total by Del Cerro 1966, Del Cerro 1966 was essentially in the position of a transferee of the McAvoy investors, and, therefore, the assumed "indebtedness" must be viewed as the same as that which derived from the transactions found to have been a sham in 1965. Accordingly, the $825,000 claimed in 1966 as interest on such alleged indebtedness cannot be allowed. Knetsch v. United States, supra.

The $245,000 of unamortized prepaid interest acquired by Del Cerro 1966 upon the liquidation of McAvoy, and subsequently written off by Del Cerro in 1966, presents a different question. Respondent contends that the $280,000 originally paid to Sunset by McAvoy as prepaid interest (of which $245,000 was the unamortized balance taken over by Del Cerro

1966), together with the $370,000 prepaid financing fee, was in substance a loan to Sunset, and not prepaid interest. Although respondent's position has considerable merit, considering all the facts and circumstances surrounding the Thousand Oaks transactions, we do not find it necessary to make a determination on that issue, since we believe that the $245,000 deduction must be disallowed for other reasons.

Even if the $245,000 acquired by Del Cerro 1966 from McAvoy is properly characterized as prepaid interest, we fail to see a legal basis for the write-off of that entire amount as a tax deduction in 1966. Section 163(a)[23] allows a deduction for interest "paid or accrued within the

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23 Unless otherwise indicated, all section references herein are to the Internal Revenue Code of 1954, as amended.

taxable year." In general, a cash basis taxpayer may deduct interest payments only in the year paid, and an accrual basis taxpayer may deduct interest only for the period in which it accrues, regardless of when paid. Section 1.461-1(a), Income Tax Regs. Massachusetts Mutual Life Insurance Company v. United States, 288 U.S. 269 (1933). McAvoy was an accrual basis taxpayer, and accordingly, the $280,000 paid to Sunset in 1965 was capitalized, to be amortized over the four-year period to which the interest related. When the unamortized balance of $245,000 was succeeded to by Del Cerro 1966 it was written off, on the grounds that Del Cerro 1966 was a cash basis taxpayer, and not required to capitalize and amortize prepaid interest. The flaw in this reasoning, however, is that even though Del Cerro 1966 was a

cash basis taxpayer, a cash basis taxpayer may deduct accrued interest only when actually paid. Section 163. Lewis C. Christensen, 40 T.C. 563 (1963). In the instant case the $245,000 was not paid by Del Cerro in 1966; it had been paid during the prior year by McAvoy. To the extent that Del Cerro 1966 may be deemed to have "paid" something when it acquired the unamortized prepaid interest account upon the liquidation of McAvoy, what it "paid" was not interest expense in 1966, but the cost of acquiring an intangible asset.

Accordingly, we hold that respondent's disallowance of the 1966 interest deductions claimed by Del Cerro 1966, in the total amount of $1,070,000 must be sustained. Cf. Rodney, Inc., 2 T.C.

1020 (1943), affd. 145 F. 2d 692 (2d Cir. 1944).[24]

Berman

For the year 1967, Del Cerro reported a loss of $4,543,035 in its partnership income tax return. Portions of this loss were deducted by the Del Cerro partners in their 1967 individual returns, and respondent has disallowed such deductions, based upon his

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[24] The disallowance of these interest deductions would still leave a net loss of $1,635.08 out of the total net loss of $1,071,635.08 originally reported by Del Cerro 1966. Although respondent's Notice of Deficiency disallows the entire claimed net loss of Del Cerro 1966, the litigation herein has been concerned only with the $1,070,000 of claimed deductions, and none of the deductions which constitute the $1,635.08 balance of the reported loss have been dealt with by either party at trial or on brief. Accordingly, petitioner, who has the burden of proof herein, must be deemed to have abandoned any claim she may have had to any portion of the remaining alleged partnership loss.

determination that the partnership in fact did not have a net loss in 1967.

Del Cerro's claimed net loss is based principally upon its "write off of intangible assets" in the amount of $6,254,500. The "intangible assets" written off were the "Contractual Rights and Interests" which had been placed on Del Cerro's books in 1966 at the time of the dissolution of McAvoy into Del Cerro, as discussed in Thompson, supra. However, petitioners have failed to establish either a legal or a factual basis for the partnership's deduction of this item.

It is true that the 1967 settlement agreements between Sunset and Del Cerro terminated the previous contractual arrangements under which Sunset was to develop the Thousand Oaks property.

Petitioners' position is that such termination represented a deductible loss to Del Cerro to the extent of the book value of Del Cerro's contractual rights, or $6,254,500. However, petitioners have failed to establish that such contractual rights had a tax basis upon which the claimed loss deduction could have been based.

Section 165 permits a loss deduction for the sudden termination of usefulness of nondepreciable property used in business or in a transaction entered into for profit. Section 1.165-2(a), Income Tax Regs. However, the amount allowable is measured by, and limited to, the tax basis of the property in question. Section 1.165-1(c)(1), Income Tax Regs. The alleged "Contractual Rights and Interests" had no tax basis. At the time that

the Thousand Oaks property was acquired by McAvoy from Sunset, and the development agreements with Sunset were executed, McAvoy recorded on its books the cost of the land ($700,000), but the so-called "Contractual Rights and Interests" arising from the development contracts were not separately recorded with their own cost basis. Indeed, they could not have been, since they did not have any cost to McAvoy. Therefore, they had no tax basis, regardless of what their value may have been to McAvoy.[25]

Petitioners contend, however, that upon the dissolution of McAvoy into Del

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25 Petitioners do not contend that any portion of the $700,000 purchase price of the land should have been allocated as the basis of the related "Contractual Rights." Compare Louisiana Land & Exploration Co. v. Commissioner, 161 F.2d 842 (5th Cir. 1947), affirming 7 T.C. 507 (1946).

Cerro in 1966, the "Contractual Rights and Interests" received by Del Cerro were properly recorded on Del Cerro's books as a separate asset with a basis of $6,254,500. We find no justification in fact or law for this contention. In Ain, supra, we have already discussed the question of whether the rights under the Sunset development agreements had any significant value beyond the cost of the Thousand Oaks property itself. There we set forth a number of reasons why we thought that they did not. Without repeating the details, suffice it to say that our discussion of this matter in Ain is equally applicable here, and that petitioners have not established that the contractual arrangements with Sunset had any separate value at the time of the dissolution of McAvoy into Del Cerro 1966.

If the so-called "Contractual Rights and Interests" involved here had in fact had a value of $6,254,500 at the time of liquidation of McAvoy, and such value had properly been assigned as basis by Del Cerro (presumably, pursuant to section 334(a)), then the McAvoy investors collectively would have realized a taxable gain in approximately that amount upon such liquidation.[26] The record does not indicate that such a gain on liquidation was recognized, and we seriously doubt

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26 Although the technical mechanics of the liquidation and dissolution of McAvoy into Del Cerro, and the assumption by Del Cerro of the McAvoy investors' notes to World Minerals, are not determinable from the record, we are unable to perceive any legal method through which Del Cerro could have recorded the "Contractual Rights and Interests" at a stepped-up basis without a corresponding recognition of gain to the McAvoy investors. Sections 331-334.

that the McAvoy investors, who (through their advisers) were highly conscious of tax planning in all of the transactions involved in these cases, would have liquidated McAvoy in a manner which would have triggered recognition of a gain of several million dollars. Thus, it would appear that in connection with the tax treatment of the liquidation of McAvoy, the McAvoy investors did not assign a $6,254,500 value to the "Contractual Rights and Interests."

For the reasons discussed above, we conclude that the so-called "Contractual Rights and Interests" had no tax basis which could have been written off as a loss under section 165. Kahan testified that the value of the development arrangements with Sunset was in the potential future gain to Del Cerro from such

development. Thus, the loss sustained by Del Cerro as a result of the termination of the development arrangements with Sunset was in the nature of a loss of an asset without an established tax basis. Loss of potential profit is not an allowable tax deduction. J. G. Boswell Company v. Commissioner, 302 F. 2d 682 (9th Cir. 1962), affg. 34 T.C. 539 (1960), cert. denied 371 U.S. 860 (1962); Frank F. Nicola, 1 B.T.A. 487 (1925).

Because the disallowance of the claimed "write off of intangible assets" in the amount of $6,254,500 totally eliminates the overall net loss reported by Del Cerro in 1967, we need not consider the propriety of the other deductions claimed in its 1967 return. On brief respondent has totally reconstructed Del Cerro's 1967 income and deductions,

based upon his view of the substance of the various transactions involved, with a resulting net income of $450,712. However, we need not make a determination as to the correctness of this amount, nor of the various adjustments through which it was derived. Since respondent has not asserted increased deficiencies based upon his alleged net income of Del Cerro in 1967, but has merely disallowed the reported loss, our disallowance of the claimed $6,254,500 deduction discussed above, which disallowance eliminates the claimed net loss, is dispositive of the Berman case in favor of respondent.

Decisions will be entered under Rule 155.

APPENDIX B

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

AUDREY M. THOMPSON, FLORENCE AIN & GREGORY AIN DOROTHY E. KAHAN & ROBERT KAHAN NANA BERMAN & WILLIAM BERMAN,	)	No. 78-2579 78-2580 78-2581 78-2582
Petitioners-Appellants,	)	
vs.	)	OPINION
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent-Appellee.	)	

Appeal from a Decision of the Tax Court of the United States

Argued July 10, 1980, Submitted July 31, 1980

Before: CHOY and TANG, Circuit Judges, and REED,* District Judge.

*Honorable Edward C. Reed, Jr., United States District Judge for the District of Nevada, sitting by designation.

TANG: Circuit Judge:

These three consolidated cases involve taxpayers who were partners and investors in a partnership and corporation that were involved in a series of transactions relating to the development of real property. These taxpayers appeal from adverse judgments of the Tax Court, which disallowed deductions taken by the taxpayers during three tax years, and which found that the transactions giving rise to the deductions lacked economic substance. The Tax Court's findings were not clearly erroneous, and we affirm its judgments.

The three cases here on appeal, in addition to a fourth that was resolved favorably to the taxpayers, were consolidated for hearing in the Tax Court because they all arose from the same compli-

cated series of transactions. The named petitioner in each case represented many other petitioners who have agreed to be bound by the outcome of this litigation. The cases were largely tried upon stipulated facts. The Tax Court's extended and accurate compilation of the facts is recounted in its opinion, Thompson v. Commissioner, 66 T.C. 1024 (1976). For our purposes, it is necessary to detail only the most pertinent facts.

A. The Kahan Case

Because of its relevance to later transactions, we include a brief summary of the facts of the unappealed Kahan case.

Robert Kahan is a certified public accountant engaged in a public accounting practice, who also promotes and organizes various real estate and

business ventures. In 1965, he began discussing possible real estate transactions with Sunset International Petroleum Corporation (Sunset), a publicly-held corporation whose primary business activity was real estate development. Sunset was anxious to generate gains from real estate sales for financial reporting purposes, such gains being offset for tax purposes by loss carryforwards and deductions for depletion and intangible drilling costs relating to Sunset's petroleum business. At the same time, Sunset wanted to maintain a continuing interest in the future development of any undeveloped land that it sold.

As a consequence of these discussions, Kahan organized 18 individuals (15 of them his clients) as a limited partnership known as Del Cerro Associates

(Del Cerro) to purchase a 112-acre section of Sunset's Del Cerro property in San Diego. One of the general partners was Ben Margolis, a lawyer and close friend of Kahan. Del Cerro paid Sunset $1,456,000 for the land by the delivery of two promissory notes. The notes provided for interest at an annual rate of 6%, payable monthly, but Del Cerro had the option, which it exercised, to prepay $350,000, the first 4 years' interest on the notes, and to defer the remaining interest until maturity of the notes. Del Cerro then entered an agreement with Lion Realty Corporation, a Sunset subsidiary, in which Lion was appointed exclusive agent with respect to the property, and, inter alia, was given the right to resell the land for no less than $2,250,000.

Del Cerro filed a tax return for the

calendar year 1965 claiming a loss of $350,000 for the prepaid interest. The Commissioner disallowed the loss and the deductions taken by the partners for their share of the loss, claiming that the $350,000 was in effect a disguised loan to Sunset that would be repaid by the eventual repurchase of the property by Sunset from Lion Realty. Although skeptical, the Tax Court found that the taxpayers had established a prima facie case of their characterization of the transaction as a legitimate business venture because, even though the Del Cerro-Lion agreement was in effect a hidden option to Sunset, Sunset was not obligated to exercise the option. Id. at 1031, 1045-49. The Commissioner does not appeal this finding.

B. The Ain Case

Harry Margolis, brother of Ben

Margolis, is a tax attorney who has dealt with all of the taxpayers in these cases in a professional capacity. A.A.G. Smeets and W.M.J. Correa headed an organization (Smeets-Correa organization) of numerous entities, some of which provide trustee and corporate management services to trusts and corporations established in the Netherlands Antilles and the Bahamas. In 1963, the Smeets-Correa organization established a trust company in the Bahamas known as Aruba Bonaire Curacao Trust Co. Ltd. (ABC). Until the spring of 1965 ABC was locally managed by, and shared office space with, a Bahamian bank. Thereafter, it acquired its own employees and office space although its officers and directors continued to be part of the Smeets-Correa Organization located in the Netherlands Antilles. Margolis

and/or his associates represented numerous clients who established trusts placed with ABC.

In June 1965, ABC purchased for $750 an inactive corporation known as the Douglas N. McAvoy Organization (McAvoy), to be used as a shell in real estate transactions. ABC contributed in cash $650,000 of its own money to the capital of McAvoy.

In August 1965, McAvoy entered into a series of real estate agreements with Sunset. First, McAvoy agreed to purchase two parcels of commercial and multi-residential land in Thousand Oaks, California, from Sunset for $700,000, to be paid by a promissory note, secured by the parcels, payable in full on September 1, 1975. The note provided for 10% annual interest. The first four years'

interest,$280,000, was due upon closing with the remainder of the interest due upon maturity of the note in 1975. The two parcels were sold as part of a larger tract that was subject to existing first mortgages that could be released for about $550,000.

Second, McAvoy, as owner of the land, contracted with Sunset to arrange financing for the construction of a shopping center and apartments upon the two parcels. Upon execution of the agreement, McAvoy agreed to pay Sunset $370,000 as a fee for Sunset's arrangement of financing. (McAvoy was responsible for paying interest on the financing.)

Third, McAvoy and Sunset also entered a joint venture agreement, by which the joint venture was to lease the Thousand Oaks parcels from McAvoy for the

purpose of operating and managing them. As rent, the joint venture was required to pay all financing costs incurred by McAvoy, to make interest-free loans to McAvoy to cover the cost of the real property improvements, and otherwise to pay all costs associated with the property. The lease also granted the joint venture an option to purchase the property on or before August 1975. The option price ranged from $1,360,000 to $1,600,000, depending on the year in which it was exercised, plus assumption of existing mortgages. In order to retain the option, the joint venture was obligated to pay McAvoy $30,000 semi-annually, to be applied to the option price. The joint venture agreement also required Sunset to maintain and exercise the option. Sunset was also obligated to advance all

other money required by the agreement for payment of rent or any other purpose and to bear all losses, but was granted broad power to manage, develop, and sell the joint venture's leasehold interest. Any net cash receipts from the operation or sale of the property would be first applied to repay Sunset's loans and advances to the joint venture and any remaining balance would be divided equally between the two.

At the closing of the agreements, McAvoy paid in cash to Sunset the $280,000 "prepaid interest" and the $370,000 financing fee. Both amounts were capitalized on the books of McAvoy, which computed its income on the accrual method. The prepaid interest was amortized on a monthly basis over the four-year period; the financing fee was not amortized.

In late 1965, ABC, which then owned

all the McAvoy stock, sold 98.53% of it to 30 individuals (the "McAvoy investors") at an aggregate price of $6,800,000, paid by individual unsecured promissory notes in favor of ABC in the full amount of the purchase price for the individual's portion of the stock. The notes bore 10% annual interest, with the first interest payment due by December 31, 1965. Payments on principal were deferred until maturity of the notes in 1972. The investors were primarily clients of Kahan and/or Margolis. ABC assigned the notes to World Minerals, a Netherlands Antilles corporation. Before December 31, 1965, the investors paid a total of $475,000 interest to World Minerals, most of the investors borrowing funds for that purpose from Universal Decorating Leasing Company, whose counsel was Harry Margolis.

Each investor deducted his payment of interest on his personal income tax returns for 1965, but the Commissioner disallowed the deductions. The Tax Court sustained the Commissioner.

C. The Thompson Case

In 1966, the interests of 18 original partners of Del Cerro in the San Diego property and the interests of the 30 McAvoy investors in the Thousand Oaks property, were combined into a new Del Cerro Associates partnership (referred to as Del Cerro 1966). Six new investors became partners in this new partnership. Del Cerro 1966 dissolved McAvoy, with McAvoy's investors becoming partners of Del Cerro 1966 and McAvoy's interests in the Thousand Oaks property and the related agreements being transferred to Del Cerro 1966. In connection with this reorganization, arrangements were made

for the cancellation of the individual notes totalling $6,800,000 held by World Minerals, and the assumption of the aggregate obligation by Del Cerro 1966. In addition, the prepaid financing fee of $370,000 and the unamortized prepaid interest of $245,000 that had been carried as assets on the books of McAvoy were carried forward on the books of Del Cerro 1966, and McAvoy's investment in the Thousand Oaks property, which had been included in the assets of McAvoy at no more than $715,000, was written up on the books of Del Cerro 1966 as an asset called "Contractual Rights and Interests" in the amount of $6,254,500. An additional $1,065,000 in capital was contributed by the Del Cerro 1966 partners to the partnership, mostly with funds borrowed for that purpose from three corporations

in which Harry Margolis had either an ownership interest or a working relationship.

In its partnership tax return for 1966, Del Cerro claimed an interest deduction of $1,070,000, consisting of (1) $825,000 paid to World Minerals as interest on the $6,800,000 obligation assumed by the McAvoy investors, and (2) $245,000 representing a complete write-off of the prepaid interest taken over by Del Cerro 1966 from the books of McAvoy. The partnership loss was allocated among the partners according to their respective 1966 cash capital contributions to the partnership. The Commissioner disallowed the resulting deductions taken by the partners on their personal returns, and the Tax Court upheld the Commissioner.

D. The Berman Case

During 1967, Sunset began experiencing financial difficulties, including a default on its agreement with Del Cerro, and began negotiations with creditors, including Del Cerro. The arrangements between Sunset and Del Cerro, relating to both San Diego and Thousand Oaks properties, were substantially revised. As a result of these revisions, the purchase money notes due from Del Cerro to Sunset with respect to the San Diego property remained in effect but without "personal" liability; Sunset was required to pay Del Cerro $1,200,000 in cash before January 15, 1968, or, at Sunset's option, deliver Del Cerro 110,000 shares of Commonwealth United Corporation stock at a price no less than $12 a share; the obligations of the parties in connection

with the development of the properties were cancelled, and the notes totalling $1,450,000 from Del Cerro to Sunset in connection with the San Diego property in effect became Sunset's collateral for performance of its new obligations to Del Cerro, meaning that failure by Sunset to perform would entitle Del Cerro to cancel the notes and reclaim the property.

Later in 1967, Del Cerro modified the terms of its $6,800,000 obligation to World Minerals that Del Cerro had assumed from the McAvoy investors. The effect of this modification was that Del Cerro would transfer to World Minerals some of its assets, including its interest in the San Diego property and the money or stock received under the revised Del Cerro-Sunset agreement, to be credited toward the $6,800,000 it owed World Minerals.

During 1967, 48 of the 54 Del Cerro partners contributed additional amounts of capital of the partnership, totalling $1,178,317.

In its partnership tax return for that year, Del Cerro reported a net loss of $4,543,035, most of which arose from a writeoff of $6,254,500 in intangible assets attributed to the termination of the agreement with Sunset to develop the Thousand Oaks property. The Commissioner disallowed the resulting partnership losses taken by the individual partners on their personal tax returns. Id. at 1044-45. This ruling was sustained by the Tax Court.

II.
Analysis

The Tax Court disallowed the deductions taken by the petitioners in these

cases because it found that the transactions creating their asserted losses lacked economic substance. "Sham" transactions, having no economic effect other than the creation of income tax losses, cannot be recognized for tax purposes. Knetsch v. United States, 364 U.S. 361 (1960).

This court will not disturb the fact findings of the Tax Court unless they are clearly erroneous. Geneva Drive In Theater, Inc. v. Commissioner, No. 77-3895, slip op at 3988 (9th Cir. July 3, 1980); First Security Bank of Idaho, 592 F.2d 1050, 1053 (9th Cir. 1979). Less clear is the appropriate standard of review where a "mixed" question of fact and law is present. Compare Lundgren v. Commissioner, 376F.2d 623,627 (9th Cir. 1967) (mixed question subject to

"review") with Parkside, Inc. v. Commissioner, 571 F.2d 1092, 1095 n.5 (9th Cir. 1977) (Pregerson, J., concurring specially) (clearly erroneous standard of review applies to questions of fact "even where arguably" mixed with law).

We need not resolve this possible conflict here, however, because we find that the Tax Court's determination whether a transaction is lacking in economic substance is essentially a factual determination, and therefore subject to the clearly erroneous standard of review. Weisbart v. Commissioner, 564 F.2d 34, 36 (10th Cir. 1978). This is because the Tax Court's inquiry is not directed toward the application of a statute or an express legal standard. Instead, it requires the Tax Court to focus on the facts and circumstances of particular

transactions and resolve whether, as a practical matter, those transactions have any economic impact outside the creation of tax deductions. Enmeshed as it is in factual considerations, the conclusion reached by the Tax Court will spring more from its experience "with the mainsprings of human conduct" rather than the application of any legalistic formula, and makes appropriate a narrow standard of review. See Commissioner v. Duberstein, 363 U.S. 278, 289-91 (1960). The expertise that the Tax Court brings to bear in its consideration of these complex factual situations provides, of course, further reason to defer to its conclusion. See Sibla v. Commissioner, 611 F.2d 1260, 1262 (9th Cir. 1980).

The taxpayers argue, in effect, that they are entitled to de novo review

because the facts in the Tax Court were largely stipulated and the cases turn on the resolution of conflicting inferences to be drawn from the facts. To the extent that the Tax Court's findings are predicated upon inferences drawn from documents and undisputed facts, however, the clearly erroneous standard of review remains applicable. See United States v. United States Gypsum Co., 333 U.S. 364, 394-95 (1948); Geneva Drive In Theater, Inc., slip op. at 3988.

We conclude that the findings of the Tax Court are not clearly erroneous.

A. The Ain Case

Despite the complex and intricate nature of many of the transactions in this case, the Tax Court's decision to disallow the deductions taken by the taxpayers generally centered on the rather

narrow circumstances surrounding the resale of 98.53% of the McAvoy stock by ABC to the 30 McAvoy investors. The Tax Court reasoned:

> In 1965, all of the stock of McAvoy, then a corporate shell, was acquired by ABC for $750. ABC subsequently contributed an additional $650,000 to the capital of McAvoy, for a total investment of $650,750. In late August 1965, the Thousand Oaks property was sold by Sunset to McAvoy for $700,000 in the form of a purchase-money mortgage. McAvoy paid Sunset an additional $280,000 in prepaid interest and $370,000 as a financing fee, which amounts were capitalized. Thus, McAvoy held assets with a book cost of $1,350,000, subject to a long-term mortgage of $700,000. Within 3 months after these transactions with Sunset, ABC resold 98.583 percent of its McAvoy stock to the 30 McAvoy investors for $6,800,000, more than 10 times its cash investment in such stock and more than 10 times the stock's book value. Under the circumstances, the bona fides of such an arrangement are suspect on their face; a purchase and resale within 3 months at a ten-fold increase in price strains reasonable credulity.

Thompson, 66 T.C. at 1051 (emphasis in original).

We too find the $6,800,000 sale inexplicable. The taxpayers argue that their purchase of McAvoy for $6,800,000 from ABC was not a sham because the real estate development for which McAvoy (then owned by ABC) and Sunset had contracted was worth nearly that much. They point to the general existence of factors (leverage, zoning, financing, labor and material costs, and marketability) that, hypothetically, could radically transform the value of the Thousand Oaks land. There is nothing in the record, however, to show that any of these factors actually operated in the months between McAvoy's purchase of the land and the sale of McAvoy to the McAvoy investors to increase the value of the land from the $700,000 paid by McAvoy to the $6,800,000 paid to ABC by the McAvoy investors for McAvoy three months later.

There are numerous reasons to believe that McAvoy was not nearly worth what the investors paid for it. Although the taxpayers point to the Sunset-McAvoy development arrangements as creating valuable rights far beyond the value of the Thousand Oaks property itself, in fact whatever additional value that accrued by reason of those arrangements must have existed at the time McAvoy purchased the land from Sunset, since both the land sale and the development agreements were part of the same set of transactions. Presumably, any enhanced value of the land resulting from the associated agreements would have been included in the sales price.

The Tax Court found it incredulous that Kahan and Harry Margolis, who were both familiar with Sunset's efforts to

sell its property, would advise the McAvoy investors to purchase McAvoy from ABC for $6,800,000 when they knew that the McAvoy investors could have acquired the same assets directly from Sunset and entered the same agreements for $700,000 only three months earlier. Although this fact alone justifies suspicion about the bona fide nature of the transactions, virtually dispositive is the fact that Sunset, through the joint venture, retained an option, which it was obliged to exercise, to repurchase the land for no more than $1,600,000. It is difficult to understand why investors would purchase land and associated development rights for $6,800,000 when those assets could be repurchased from them at any time for considerably less.

The Tax Court's explanation why the McAvoy investors may have entered this arrangement was that ABC may have been intentionally interpositioned between Sunset and the McAvoy from the outset in order artificially to create tax deductions. Although not necessary to sustain its decision, the inference was quite reasonable. With the possible exception of Sunset, the entities involved in these transactions were interrelated either through ownership or their association with Harry Margolis or Kahan. In particular, Margolis' connections with both the McAvoy investors and ABC, a small trust company funded by an unknown trust, strongly suggests that the intermediary role of ABC was purely artificial.

Given all of the above, the Tax Court was not required to credit the

testimony of Kahan that the property would bring the McAvoy investors a profit of $10,000,000. See Potts, Davis, & Co. v. Commissioner, 431 F.2d 1222, 1225-26 (9th Cir. 1970).[1]

B. The Thompson Case

In Thompson, the Tax Court disallowed both the deductions of the $825,000 paid to World Minerals as interest on the $6,800,000 in notes assumed by Del Cerro 1966 and the $245,000 representing a writeoff of the prepaid interest account taken over by Del Cerro 1966 from the books of McAvoy.

The taxpayers present no argument in their brief to suggest that the $245,000 was incorrectly disallowed, and in fact, conceded in their motion for reconsideration that the Tax Court was correct in disallowing this deduction. In any event,

the Tax Court's disposition of this item was correct because a cash basis taxpayer, like Del Cerro 1966, may deduct accrued interest only in the year paid, 26 C.F.R. Sec. 1.461-1(a), and the $245,000 interest was not paid by Del Cerro in 1966 but in 1965 by McAvoy.

With regard to the $825,000, it must be treated the same as the $475,000 interest claimed in the prior year by the Ain taxpayers. In the Ain case, the $475,000 was interest paid to World Minerals in 1965 by the Del Cerro 1966 partnership, which had assumed in full the notes of the McAvoy investors after the merger of the McAvoy investors and the 18 original Del Cerro partners.[2]

C. The Berman Case

In this case, the Tax Court disallowed the loss of $4,543,035 taken by

the Del Cerro partnership in 1967 because it would not permit Del Cerro to write off $6,254,500 as a loss of contractual rights upon its termination of the development agreement with Sunset. Again, the analysis in Ain is controlling.

Under Section 165 of the Internal Revenue Code, a loss deduction is allowed for the sudden termination of usefulness of property in a transaction entered into for profit, but the amount of the deduction allowable is limited to the tax basis of the property in question. The Tax Court found that, at the time the Thousand Oaks property was acquired by McAvoy from Sunset and the development agreements executed, McAvoy recorded on its books the cost of the land ($700,000) but not any "contractual rights and interests." These rights were not (and

could not be) separately recorded with their own cost basis because they did not have any cost to McAvoy. Nevertheless, when McAvoy was dissolved into Del Cerro 1966, Del Cerro 1966 recorded $6,254,500[3] in "contractual rights and interests" as a separate asset received from McAvoy. The court found no justification for this evaluation in light of its earlier analysis in Ain that the $6,800,000 purchase of the McAvoy stock was a sham.

Because, as we decided in Ain and Thompson, the taxpayers failed to justify their purchase for $6,800,000 of property worth only $700,000 three months earlier, it follows that the Del Cerro write-up of contractual rights, based on the same overvaluation of Thousand Oaks property and associated agreements, also had no basis. The taxpayers insist, however,

that the contractual rights and interests had a tax basis. In a liquidation, the tax basis of the property received by the distributee (here Del Cerro 1966) equals the fair market value of the property. 26 U.S.C. Section 334(a). The taxpayers argue that the only evidence of the fair market value of the McAvoy assets was the amount they actually paid for them, i.e., the $6,800,000 paid by the McAvoy investors to ABC, and, later, the assumption of $6,800,000 in notes by Del Cerro 1966 in exchange for the McAvoy assets. Although the amount paid for assets in an arm's length transaction might be evidence of their fair market value, the taxpayers' argument ignores the central finding of the Tax Court that the assets here simply did not have the value that the taxpayers ascribed to them.

The taxpayers also argue that their basis in the partnership should be increased by their intermittent cash contributions of capital to the partnership. This argument misses the point. Partnership income or loss is determined at the partnership level and not at the level of the individual partners. The distributive share of income or loss of the individual partners can be determined only by reference to the income or loss of the partnership itself. See 26 U.S.C. Sections 701-704; United States v. Bause, 410 U.S. 441 (1973). Here, the taxpayers failed to show that the partnership itself had a tax basis in the contractual rights through which they could claim their distributive share.

In their reply brief, taxpayers raise the issue of collateral estoppel

through the citation of two cases decided after their opening brief was filed, Parklane Hosiery, Inc. v. Shore, 99 S.Ct. 645 (1979), and Starker v. United States, 602 F.2d 1341 (9th Cir. 1979). They argue that the Tax Court's unappealed decision against the Commissioner in Kahan should be considered the "first case" and have collateral estoppel effect in "the second litigation," the Ain, Thompson, and Berman cases.

Even though Parklane and Starker were intervening cases, the doctrine of collateral estoppel itself is hardly new. The general rule is that appellants cannot raise a new issue for the first time in their reply briefs. See United States v. Puchi, 441 F.2d 697, 703 (9th Cir.), cert. denied, 404 U.S. 853 (1971). Even were we to review this issue, we would reject

it. In Starker, the court held that the Government was collaterally estopped from relitigating the taxpayer's right to a tax refund where it had earlier lost its case against the taxpayer's son that was based on the same contract involved in the taxpayer's case. The Kahan case was litigated on the basis of significantly different facts than "the second litigation." Most conspicuously, the fact most damaging to the taxpayers here -- the inflated resale of the McAvoy stock -- is not present in the Kahan transactions.

The judgment of the Tax Court is affirmed.

FOOTNOTES

[1]One of the few factual findings genuinely disputed by the taxpayers is the Tax Court's statement that, at the time the development arrangements with Sunset were entered, "Sunset's ability to perform must have been at least questionable." Thompson, 66 T.C. at 1051. The taxpayers

point to evidence suggesting that Sunset was financially sound at the time. This factual dispute, however, is not material. The Tax Court did not rely on Sunset's financial health in drawing its conclusion. Nor is Sunset's financial picture relevant, since it is the ABC sale of McAvoy to the McAvoy investors, not the original Sunset-McAvoy transactions, that is the primary subject of this controversy.

[2]The taxpayers provide no explanation why the taxpayers paid $475,000 in interest on the $6,800,000 notes in 1965 and $825,000 on the same principal at the same rate of interest in 1966. The Government suggests that this erratic repayment schedule demonstrates that the taxpayers were claiming losses in the years that it would do them the most good.

[3]The taxpayers do not explain how they computed the $6,254,500 sum.

APPENDIX C

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

AUDREY M. THOMPSON, FLORENCE AIN & GREGORY AIN, DOROTHY E. KAHAN & ROBERT KAHAN, NANA BERMAN & WILLIAM BERMAN, Petitioners-Appellants, vs. COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee.	No. 78-2579 No. 78-2580 No. 78-2581 No. 78-2582 ORDER

Before: CHOY and TANG, Circuit Judges, and REED,* District Judge.

The court has considered the Petition for Rehearing. The Petition for Rehearing is denied.

*Honorable Edward C. Reed, Jr., United States District Judge for the District of Nevada, sitting by designation.

No. 78-2579
No. 78-2580
No. 78-2581
No. 78-2582

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

AUDREY M. THOMPSON,
FLORENCE AIN and GREGORY AIN,
DOROTHY E. KAHAN and ROBERT KAHAN,
NANA BERMAN and WILLIAM BERMAN,

Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

ON APPEAL FROM THE DECISION OF THE
UNITED STATES TAX COURT

PETITION FOR REHEARING

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November 17, 1980

AUDREY M. THOMPSON, FLORENCE AIN AND GREGORY AIN, DOROTHY E. KAHAN and ROBER KAHAN, NANA BERMAN and WILLIAM BERMAN, Appellants,	)	NOS. 78-2579 78-2580 78-2581 78-2582
v.	)	
COMMISSIONER OF INTERNAL REVENUE, Appellee.	)	

PETITION FOR REHEARING

The Court's attention is directed to material errors of fact or law which appear to have been overlooked in the decision. The decision recites statements of facts. Such facts are not controverted. The only testimony in the trial court was that of Robert Kahan. It was favorable to appellants. It can thus be said that the entire record is a stipulated record. The issues must be decided

on the basis of uncontradicted evidence.

It is the failure of the Tax Court to decide the case on the basis of uncontradicted evidence that appellants believe to be in error. It is not the decision but how we got there that is not supportable and which appellants call to the attention of the Court in this petition for rehearing.

I

THE ISSUES

Appellants assume at this point that a trial court may reject evidence in an uncontradicted record. Appellants claim that it is error for such trial court to make an affirmative finding contrary to uncontradicted evidence because there is no choice to be made. In our case, the court rejects a series of transactions that are stipulated to in the record and

are not contradicted. The court does not stop there. It goes further and says the exact reverse is the proper finding, even though no such reverse stipulation or evidence is to be found in the record. It is one thing for a court to conclude, as here, that the assets simply did not have the value that the taxpayers ascribed to them. May the court disregard finding any value?

In addition, appellants call to the attention of this Court these specific errors:

a. It is error to state that Sunset could repurchase the land for no more than $1,600,000.

b. It is error for the Court to fail to identify the $245,000 of prepaid interest as an item for any purpose.

c. It is error for the Court to

overlook the manner in which the $6,254,500 sum was computed.

The foregoing issues support the granting of a rehearing.

II

DISCUSSION

The heart of the issues can be found in the statement of the decision that it was concerned with "the resolution of conflicting inferences to be drawn from the facts." (Decision, 10/22) This is not accurate. The record contains uncontradicted evidence from which only one inference can be drawn. What has happened is that the trial court has chosen not to draw that inference. It is appellants' position that it is error to draw the opposite inference without any evidentiary support in the record.

The "clearly erroneous" test does not even arise absent a foundation for the finding in the first instance. It is this application of the "clearly erroneous" test that appellants argue is error. The cases cited by the Court are simply not applicable absent choice among conflicting inferences.

For example, valuation of the stock is a critical issue. There is evidence of value in the record. There is no contradictory evidence of value in the record. The decision appears to authorize a psychological or experiential approach to create evidence of value not found in the record. Appellants urge under these circumstances that a trial court should be limited to ordering further trial with reference to rejected facts contained in uncontradicted stipulations.

For example, the decision correctly sets forth a history of payments. In Ain, $650,000 of cash was actually paid out. (Decision 5/28) $475,000 interest was paid in Ain. (Decision 6/14). In Thompson, $1,070,000 was expensed, of which $825,000 was cash and $245,000 represented a write-off of prepaid interest. (Decision 7/18-23) In Berman, $1,178,317 was contributed by the partners and spent. (Decision 8/29) The evidentiary record is clear that the sums noted were dispersed by appellants and never recovered. Appellants submit that it is error to ignore the actual out-of-pocket net cost to the taxpayer.

To the same effect, the decision errs in its treatment of partnership basis. The decision correctly notes that a loss deduction is allowed for the sudden

termination of usefulness of property in a transaction entered into for profit. Ignored by the decision is its own statement of facts as to the payments that were actually made by the partnership or its predecessor in interest on account of the rights acquired. Thus, if the $245,000 of prepaid interest is not deductible, it certainly becomes a cost. If the payments set forth in the decision were not deductible currently, they certainly become a part of the cost.

In other words, the partners made cash contributions to the partnership. The partnership used such cash to pay on account of the contractual rights. Such payments gave rise to a basis for the partnership in such rights. These facts are found in the decision itself. The resulting partnership losses in 1967

should then be distributable to the partners.

The decision errs fundamentally when it states:

> Although this fact alone justifies suspicion about the bona fide nature of the transactions, virtually dispositive is the fact that Sunset, through the joint venture, retained an option, which it was obliged to exercise, to repurchase the land for no more than $1,600,000. It is difficult to understand why investors would purchase land and associated development rights for $6,800,000 when those assets could be repurchased from them at any time for considerably less.
>
> (Decision 12/21-29)
>
> [Emphasis added.]

Certainly, for anyone to pay $6,800,000 for assets that could be lost at any time for less than 25% of that sum would be nonsense. This "nonsense" is simply an error. This error is not found in the statement of facts in the decision beginning at page 3 and running

through the first part of page 9. The "virtually dispositive" conclusion overlooks the following facts:

a. McAvoy and Sunset were engaged in a joint venture.

b. Sunset was required to purchase the land from McAvoy for the joint venture with Sunset putting up all the money. In other words, McAvoy received the $1,600,000 while retaining a half interest in the property.

c. In addition to the $1,600,000 to be paid by Sunset, Sunset was required to pay off the outstanding $700,000 deed of trust.

d. Sunset was required to advance millions of dollars at a fixed interest rate so that the joint venture could build the apartment house and shopping center complex.

e. McAvoy shared profits but was guaranteed against losses from the joint venture.

f. The benefits of depreciation went to McAvoy.

g. Sunset assigned to McAvoy deeds of trust totalling $1,456,000 as security for performance by Sunset of its joint venture obligations.

h. McAvoy had the benefit of substantial leverage and current deductibility of out-of-pocket advances.

The $6,254,500 item represented the adjusted balance of the $6,800,000 originally due under the note. (Exhibit 45 AS)

III

CONCLUSION

Sunset paid more than $3,000,000 to escape the consequences of the contractual rights acquired by McAvoy from Sunset in 1965. It is one thing to say that the assets were over-valued by the taxpayers. There is no way it can be argued that Sunset valued the assets at less than $3,000,000. Literally, the decision and that of the Tax Court below result in such valuation disappearing. Can such a conclusion be fair? If Sunset had not fallen on evil days and had gone ahead and completed the project, the IRS would have had no difficulty asserting its interest in sharing in the profits. Under these circumstances, is it fair for the IRS to resist sharing in the losses?

Appellants have never sought one dollar of deduction in these cases beyond their actual out-of-pocket contributions. This petition for rehearing should be granted so that such actual out-of-pocket losses can be determined and allowed as they should have been fifteen years ago.

DATED: November 18, 1980.

Respectfully submitted,

HARRY MARGOLIS
A PROFESSIONAL CORPORATION

By /s/
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CERTIFICATE OF SERVICE

This is to certify that four copies of the attached Petition for Rehearing in Thompson, et al., Nos. 78-2579, 78-2580, 78-2581 and 78-2582, have been mailed this date to appellee's counsel:

The Honorable M. Carr Ferguson
Assistant Attorney General - Tax Division
Department of Justice
Washington, D.C. 20530

Attention: Bruce Johnson, Esquire

DATED: November 19, 1980.

/s/

Harry Margolis
Counsel for Appellants

APPENDIX D

INTERNAL REVENUE CODE

SECTIONS 1311-14, INCLUSIVE

Part II - Mitigation of Effect of Limitations and Other Provisions

Sec. 1311. Correction of error.
Sec. 1312. Circumstances of adjustment.
Sec. 1313. Definitions.
Sec. 1314. Amount and method of adjustment.

[Sec. 1311]

SEC. 1311. CORRECTION OF ERROR.

[Sec. 1311(a)]

(a) GENERAL RULE.--If a determination (as defined in section 1313) is described in one or more of the paragraphs of section 1312 and, on the date of the determination, correction of the effect of the error referred to in the applicable paragraph of section 1312 is

prevented by the operation of any law or rule of law, other than this part and other than section 7122 (relating to compromises), then the effect of the error shall be corrected by an adjustment made in the amount and in the manner specified in section 1314.

[Sec. 1311(b)]

(b) CONDITIONS NECESSARY FOR ADJUSTMENT.--

(1) MAINTENANCE OF AN INCONSISTENT POSITION.--Except in cases described in paragraphs (3)(B) and (4) of section 1312, an adjustment shall be made under this part only if--

(A) in case the amount of the adjustment would be credited or refunded in the same manner as an overpayment under section 1314, there is adopted in the determination a position

maintained by the Secretary, or

(B) in case the amount of the adjustment would be assessed and collected in the same manner as a deficiency under section 1314, there is adopted in the determination a position maintained by the taxpayer with respect to whom the determination is made,

and the position maintained by the Secretary in the case described in subparagraph (A) or maintained by the taxpayer in the case described in subparagraph (B) is inconsistent with the erroneous inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be.

(2) CORRECTION NOT BARRED AT TIME OF ERRONEOUS ACTION.--

(A) DETERMINATION DESCRIBED IN SECTION 1312 (3)(B).--In the

case of a determination described in section 1312(3)(B) (relating to certain exclusions from income), adjustment shall be made under this part only if assessment of a deficiency for the taxable year in which the item is includible or against the related taxpayer was not barred, by any law or rule of law, at the time the Secretary first maintained, in a notice of deficiency sent pursuant to section 6212 or before the Tax Court, that the item described in section 1312(3)(B) should be included in the gross income of the taxpayer for the taxable year to which the determination relates.

(B) DETERMINATION DESCRIBED IN SECTION 1312(4).--In the case of a determination described in section 1312(4) (relating to disallowance of certain deductions and credits), adjustment

shall be made under this part only if credit or refund of the overpayment attributable to the deduction or credit described in such section which should have been allowed to the taxpayer or related taxpayer was not barred, by any law or rule of law, at the time the taxpayer first maintained before the Secretary or before the Tax Court, in writing, that he was entitled to such deduction or credit for the taxable year to which the determination relates.

(3) EXISTENCE OF RELATIONSHIP.--In case the amount of the adjustment would be assessed and collected in the same manner as a deficiency (except for cases described in section 1312(3)(B)), the adjustment shall not be made with respect to a related taxpayer unless he stands in such relationship to the taxpayer at the time the latter first

maintains the inconsistent position in a return, claim for refund, or petition (or amended petition) to the Tax Court for the taxable year with respect to which the determination is made, or if such position is not so maintained, then at the time of the determination.

[Sec. 1312]

SEC. 1312. CIRCUMSTANCES OF ADJUSTMENT.

The circumstances under which the adjustment provided in section 1311 is authorized are as follows:

(1) DOUBLE INCLUSION OF AN ITEM OF GROSS INCOME.--The determination requires the inclusion in gross income of an item which was erroneously included in the gross income of the taxpayer for another taxable year or in the gross income of a related taxpayer.

(2) DOUBLE ALLOWANCE OF A

DEDUCTION OR CREDIT.--The determination allows a deduction or credit which was erroneously allowed to the taxpayer for another taxable year or to a related taxpayer.

(3) DOUBLE EXCLUSION OF AN ITEM OF GROSS INCOME.--

(A) ITEMS INCLUDED IN INCOME.--The determination requires the exclusion from gross income of an item included in a return filed by the taxpayer or with respect to which tax was paid and which was erroneously excluded or omitted from the gross income of the taxpayer for another taxable year, or from the gross income of a related taxpayer; or

(B) ITEMS NOT INCLUDED IN INCOME.--The determination requires the exclusion from gross income of an item not included in a return filed by the

taxpayer and with respect to which the tax was not paid but which is includible in the gross income of the taxpayer for another taxable year or in the gross income of a related taxpayer.

(4) DOUBLE DISALLOWANCE OF A DEDUCTION OR CREDIT.--The determination disallows a deduction or credit which should have been allowed to, but was not allowed to, the taxpayer for another taxable year, or to a related taxpayer.

(5) CORRELATIVE DEDUCTIONS AND INCLUSIONS FOR TRUSTS OR ESTATES AND LEGATEES, BENEFICIARIES, OR HEIRS.--The determination allows or disallows any of the additional deductions allowable in computing the taxable income of the estates or trusts, or requires or denies any of the inclusions in the computation of taxable income of beneficiaries, heirs,

or legatees, specified in subparts A to E, inclusive (secs. 641 and following, relating to estates, trusts, and beneficiaries) of part I of subchapter J of this chapter, or corresponding provisions of prior internal revenue laws, and the correlative inclusion or deduction, as the case may be, has been erroneously excluded, omitted, or included, or disallowed, omitted, or allowed, as the case may be, in respect of the related taxpayer.

(6) CORRELATIVE DEDUCTIONS AND CREDITS FOR CERTAIN RELATED CORPORATIONS.--The determination allows or disallows a deduction (including a credit) in computing the taxable income (or, as the case may be, net income, normal tax net income, or surtax net income) of a corporation, and a correlative deduction or

credit has been erroneously allowed, omitted, or disallowed, as the case may be, in respect of a related taxpayer described in section 1313(c)(7).

(7) BASIS OF PROPERTY AFTER ERRONEOUS TREATMENT OF A PRIOR TRANSACTION.--

(A) GENERAL RULE.--The determination determines the basis of property, and in respect of any transaction on which such basis depends, or in respect of any transaction which was erroneously treated as affecting such basis, there occurred,with respect to a taxpayer described in subparagraph (B) of this paragraph, any of the errors described in subparagraph (C) of this paragraph.

(B) TAXPAYERS WITH RESPECT TO WHOM THE ERRONEOUS TREATMENT OCCURRED.--The taxpayer with respect to whom the

erroneous treatment occurred must be--

(i) the taxpayer with respect to whom the determination is made,

(ii) a taxpayer who acquired title to the property in the transaction and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title, or

(iii) a taxpayer who had title to the property at the time of the transaction and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title, if the basis of the property in the hands of the taxpayer with respect to whom the determination is made is determined under section 1015(a) (relating to the basis of property acquired by gift).

(C) PRIOR ERRONEOUS TREATMENT. --With respect to a taxpayer described in

subparagraph (B) of this paragraph--

(i) there was an erroneous inclusion in, or omission from, gross income,

(ii) there was an erroneous recognition, or nonrecognition, of gain or loss, or

(iii) there was an erroneous deduction of an item properly chargeable to capital account or an erroneous charge to capital account of an item properly deductible.

[Sec. 1313]

SEC. 1313. DEFINITIONS.

[Sec. 1313(a)]

(a) DETERMINATION.--For purposes of this part, the term "determination" means--

(1) a decision by the Tax Court or a judgment, decree, or other order by any court of competent jurisdiction,

which has become final;

(2) a closing agreement made under section 7121;

(3) a final disposition by the Secretary of a claim for refund. For purposes of this part, a claim for refund shall be deemed finally disposed of by the Secretary--

(A) as to items with respect to which the claim was allowed, on the date of allowance of refund or credit or on the date of mailing notice of disallowance (by reason of offsetting items) of the claim for refund, and

(B) as to items with respect to which the claim was disallowed, in whole or in part, or as to items applied by the Secretary in reduction of the refund or credit, on expiration of the time for instituting suit with respect thereto

(unless suit is instituted before the expiration of such time); or

(4) under regulations prescribed by the Secretary, an agreement for purposes of this part, signed by the Secretary and by any person, relating to the liability of such person (or the person for whom he acts) in respect of a tax under this subtitle for any taxable period.

[Sec. 1313(b)]

(b) TAXPAYER.--Notwithstanding section 7701(a)(14), the term "taxpayer" means any person subject to a tax under the applicable revenue law.

[Sec. 1313(c)]

(c) RELATED TAXPAYER.--For purposes of this part, the term "related taxpayer" means a taxpayer who, with the taxpayer with respect to whom a determination is made, stood, in the taxable year with

respect to which the erroneous inclusion, exclusion, omission, allowance, or disallowance was made, in one of the following relationships:

(1) husband and wife,

(2) grantor and fiduciary,

(3) grantor and beneficiary,

(4) fiduciary and beneficiary, legatee, or heir,

(5) decedent and decedent's estate,

(6) partner, or

(7) member of an affiliated group of corporations (as defined in section 1504).

[Sec. 1314]

SEC. 1314. AMOUNT AND METHOD OF ADJUSTMENT.

[Sec. 1314(a)]

(a) ASCERTAINMENT OF AMOUNT OF

ADJUSTMENT.--In computing the amount of an adjustment under this part there shall first be ascertained the tax previously determined for the taxable year with respect to which the error was made. The amount of the tax previously determined shall be the excess of--

(1) the sum of--

(A) the amount shown as the tax by the taxpayer on his return (determined as provided in section 6211(b)(1), (3), and (4), relating to the definition of deficiency), if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus

(B) the amounts previously assessed (or collected without assessment) as a deficiency, over--

(2) the amount of rebates, as defined in section 6211(b)(2), made.

There shall then be ascertained the increase or decrease in tax previously determined which results solely from the correct treatment of the item which was the subject of the error (with due regard given to the effect of the item in the computation of gross income, taxable income, and other matters under this subtitle). A similar computation shall be made for any other taxable year affected, or treated as affected, by a net operating loss deduction (as defined in section 172) or by a capital loss carryback or carryover (as defined in section 1212), determined with reference to the taxable year with respect to which the error was made. The amount so ascertained (together with any amounts wrongfully collected as additions to the tax or interest, as a result of such error) for each tax-

able year shall be the amount of the adjustment for that taxable year.

[Sec. 1314(b)]

(b) METHOD OF ADJUSTMENT.--The adjustment authorized in section 1311(a) shall be made by assessing and collecting, or refunding or crediting, the amount thereof in the same manner as if it were a deficiency determined by the Secretary with respect to the taxpayer as to whom the error was made or an overpayment claimed by such taxpayer, as the case may be, for the taxable year or years with respect to which an amount is ascertained under subsection (a), and as if on the date of the determination one year remained before the expiration of the periods of limitation upon assessment or filing claim for refund for such taxable year or years. If, as a result of a determination

described in section 1313(a)(4), an adjustment has been made by the assessment and collection of a deficiency or the refund or credit of an overpayment, and subsequently such determination is altered or revoked, the amount of the adjustment ascertained under subsection (a) of this section shall be redetermined on the basis of such alteration or revocation and any overpayment or deficiency resulting from such redetermination shall be refunded or credited, or assessed and collected, as the case may be, as an adjustment under this part. In the case of an adjustment resulting from an increase or decrease in a net operating loss or net capital loss which is carried back to the year of adjustment, interest shall not be collected or paid for any period prior to the close of the taxable year

in which the net operating loss or net capital loss arises.

[Sec. 1314(c)]

(c) ADJUSTMENT UNAFFECTED BY OTHER ITEMS.--The amount to be assessed and collected in the same manner as a deficiency, or to be refunded or credited in the same manner as an overpayment, under this part, shall not be diminished by any credit or set-off based upon any item other than the one which was the subject of the adjustment. The amount of the adjustment under this part, if paid, shall not be recovered by a claim or suit for refund or suit for erroneous refund based upon any item other than the one which was the subject of the adjustment.

[Sec. 1314(d)]

(d) PERIODS FOR WHICH ADJUSTMENTS MAY BE MADE.--No adjustment shall be

made under this part in respect of any taxable year beginning prior to January 1, 1932.

[Sec. 1314(e)]

(e) TAXES IMPOSED BY SUBTITLE C.--This part shall not apply to any tax imposed by subtitle C (sec. 3101 and following relating to employment taxes).

No. 80-1700

MAY 27 19
ALEXANDER L. S
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1980

AUDREY M. THOMPSON, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

WADE H. MCCREE, JR.
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MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The question presented by the petition in this federal income tax case is whether the Tax Court, having disallowed certain claimed deductions for the years in issue, was required to decide whether the disallowed deductions would result in adjustments to basis that could affect petitioners' taxable income in subsequent years. We submit that the Tax Court was not required to decide the basis question, and that, at all events, that question is not properly before this Court because it was not properly before the Tax Court or the court of appeals and therefore was never raised below.

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* In addition to the named parties, several other persons, who are or were members of the partnerships or shareholders of the entities involved in this case, have stipulated that the decision below will govern the outcome of those issues in their cases as well. A list of these persons is set forth in the Tax Court opinion (Pet. App. 7 n.1).

The pertinent facts may be summarized as follows:

a. *Florence Ain and Gregory Ain.* In August 1965, Aruba Bonaire Curacao Trust Company (ABC), a Bahamian trust company, through a shell corporation, Douglas R. McAvoy Organization (McAvoy), purchased some land from Sunset International Petroleum Corporation (Sunset) known as Thousand Oaks. In order to finance the transaction, ABC contributed $650,000 in cash to the capital of McAvoy. McAvoy agreed to purchase the land from Sunset for $700,000, payable under a 10-year 10% promissory note. Interest for the first four years ($280,000) was paid in advance. McAvoy also retained Sunset to construct a shopping center and apartment buildings on the land. In return for arranging the financing, McAvoy paid Sunset a financing fee of $370,000 in advance (Pet. App. 30-34).

McAvoy and Sunset then formed a joint venture which leased the property from McAvoy, assumed all financing costs, and agreed to pay all other costs and expenses relating to the property. The lease granted the joint venture an option to purchase the property; the joint venture agreement provided that the option would be exercised at a price not to exceed $1,600,000, and that Sunset would provide all the funds to exercise the option. Sunset also had exclusive power to manage and even to sell the joint venture's interest in the leasehold (Pet. App. 34-38).

In October and November of 1965, ABC sold 98% of the McAvoy stock to 30 individuals, collectively referred to as the McAvoy investors, for $6,800,000 in unsecured promissory notes (Pet. App. 40-41). McAvoy's only asset, other than the prepaid interest and financing fees, was the $700,000 piece of land. ABC assigned the notes to World Minerals, N.V., a Bahamas corporation with close ties to ABC. During 1965, the McAvoy investors paid $475,000 to World Minerals, purportedly as interest on these notes

(Pet. App. 41-42)[1] On audit, the Commissioner disallowed the claimed interest deductions. In this proceeding brought by petitioners Florence Ain and Gregory Ain, who were included in the group of McAvoy investors, the Tax Court upheld the Commissioner, concluding that ABC's purported purchase of the property through McAvoy, followed by the sale of substantially all the stock of McAvoy itself at a price almost ten times the price of the land, was not a bona fide transaction (Pet. App. 96-97). The court of appeals affirmed. It found the transaction to be inexplicable in view of the unexplained increase in price (Pet. App. 23), and in view of Sunset's retained right to repurchase the property for $1,600,000 (Pet. App. 25).

b. *Audrey M. Thompson.* In 1966, Del Cerro Associates, a partnership, and the McAvoy investors entered into a new partnership, also called Del Cerro Associates. The members of the original partnership contributed their interest in other land purchased from Sunset, and the McAvoy investors contributed their stock in McAvoy. The new partnership also assumed the $6,800,000 obligation that the McAvoy investors owed to World Minerals. McAvoy was dissolved and the prepaid loan commitment fee of $370,000, and the prepaid interest of $245,000 ($280,000 net of amortization), which had been carried as assets on McAvoy's books, were carried forward onto the books of Del Cerro. McAvoy's investment in the Thousand Oaks property was recorded on the books of Del Cerro by the introduction of a new assets described as " 'Contractual Rights and Interests' " in the amount of $6,254,500 (Pet. App. 45-48).

The Del Cerro partners contributed $1,065,000 additional cash to the partnership in 1966 (Pet. App. 49). In its partnership return for 1966, Del Cerro claimed an interest

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[1]Of this amount, petitioner Florence Ain deducted $5,000 as her aliquot share of the partnership deduction (Pet. App. 43).

deduction of $1,070,000, consisting of $825,000 paid to World Minerals as interest on the $6,800,000 obligation, and $245,000, representing a write-off of the prepaid interest account carried over from the books of McAvoy (Pet. App. 51-52).[2] The Tax Court upheld the Commissioner's disallowance of the deductions on the grounds that the $6,800,000 of indebtedness was a sham (Pet. App. 97-98), and that the $245,000 had never been "paid" by the partnership, but was paid by McAvoy (Pet. App. 101). The court of appeals affirmed on the same ground (Pet. App. 27-28).

c. *William Berman.* During 1967, Sunset experienced serious financial difficulties, and renegotiated its agreements with Del Cerro concerning the Thousand Oaks property. Pursuant to the renegotiation, Del Cerro was relieved of personal liability on the notes used to purchase the Thousand Oaks property, and those and other notes became collateral for Sunset's obligation to exercise the repurchase option. Moreover, Sunset was required to pay Del Cerro $1,200,000 in cash or an equivalent amount of Commonwealth United Corporation (CUC) common stock. All other obligations of the parties to each other were cancelled, except that if Sunset failed to pay the $1,200,000 it would remain obligated to exercise the option to repurchase the property (Pet. App. 58-62).

Del Cerro also modified its agreement with World Minerals so that Del Cerro was relieved of any obligation to pay interest on the loan provided the loan was paid in full by December 31, 1970. Furthermore, Del Cerro was to transfer certain assets to World Minerals in partial payment of the debt (Pet. App. 63-66).

During 1967, the Del Cerro partners contributed an additional $1,178,317 to the partnership. Del Cerro reported a

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[2]Petitioner Thompson deducted $15,000 as her share of the partnership deduction (Pet. App. 52, 56).

net loss, resulting primarily from the write-off of the contractual rights and interests in the amount of $6,254,500 (Pet. App. 65-66). The loss was allocated among the taxpayers in some undisclosed manner (Pet. App. 67 n.17).[3] The Tax Court disallowed the loss on the grounds that the partnership had no tax basis in the contractual rights written off (Pet. App. 108), and the court of appeals affirmed (Pet. App. 30-31).

1. Petitioners do not challenge the correctness of the lower courts' findings (Pet. 5), nor do they claim any conflict with any other judicial decisions (Pet. 7). Rather, they appear to argue (Pet. 5-7) that their petition should be granted because the courts below failed to declare what effect the disallowed deductions had on their basis in the partnership in 1967.

The question of the partners' basis in the partnership in that year, however, was not properly before the Tax Court. If, in fact, the partnership had suffered the claimed losses, each taxpayer's basis may have been relevant to limit his or her share of the loss under Section 704(d) of the Code. Since petitioners do not challenge the disallowance of the interest and loss deductions, however, their basis in the partnership is relevant only for determining allowable losses in subsequent years, or in determining their ultimate gain or loss on disposition of their partnership interests. See Sections 736 and 741 of the Internal Revenue Code of 1954 (26 U.S.C.).

Petitioners do not claim that a dissolution of the partnership took place in 1967, nor do they claim that there were any sales of the partnership interests during the years in issue on which gain or loss would be realized. The Tax Court's jurisdiction, with exceptions not relevant here, is

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[3]Petitioner Berman claimed a loss of $19,937.35 as his share of the partnership loss (Pet. App. 67).

limited to determining deficiencies or overpayments of tax for the years in which the Commissioner has determined a deficiency and the taxpayer has filed a petition for review. *Commissioner* v. *Gooch Milling & Elevator Co.*, 320 U.S. 418, 420 (1943); *Morse* v. *United States*, 494 F. 2d 876, 879 (9th Cir. 1974); *Commissioner* v. *Smith Paper, Inc.*, 222 F. 2d 126, 129 (1st Cir. 1955). In the absence of some showing that petitioners' basis in the partnership would affect the correct determination of their tax liability in years before the Tax Court, the fact that the Tax Court did not make a gratuitous finding as to the amount of that basis was not error. *LTV Corp.* v. *Commissioner*, 64 T.C. 589 (1975); see also Sections 6214(a), 6512(b), 7442 of the Code.

2. Nor was the Tax Court required to determine petitioners' basis for their partnership interests simply because such basis may be relevant in a subsequent year. Petitioners' argument (Pet. 5) that it is incumbent on the Commissioner[4] and the courts to dispose of all the issues before them in any one proceeding or for any one tax year, regardless of whether the issues affect tax liability for that year, is wrong. As we have noted, the Tax Court is a court of limited jurisdiction, and Section 6214(b) of the Code specifically provides that the Tax Court may not determine whether the tax for years not before it may have been overpaid or underpaid. *Commissioner* v. *Gooch Milling & Elevator Co., supra.* Thus, even if the disallowance of expenses by the Tax Court in 1965, 1966 or 1967 resulted in basis adjustments that would affect the gain on disposition of the partnership interests in some subsequent year—a proposition that is not self-evident and must be established by taxpayers—the Tax Court would still have no jurisdiction to determine that ultimate gain or loss until deficiency

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[4]Although petitioners assert (Pet. 6) that this result is required by the Treasury Regulations, they fail to cite any specific Regulations in support of their contention.

notices for those years were issued, and petitions for redetermination were timely filed. Indeed, any finding as to basis under these circumstances would closely resemble a declaratory judgment with respect to taxes, which, with exceptions not here relevant, is beyond the Tax Court's jurisdiction. *LTV Corp.* v. *Commissioner, supra; W.W. Windle Co.* v. *Commissioner,* 550 F. 2d 43, 45-46 (1st Cir. 1977). See generally *Bob Jones University* v. *Simon,* 416 U.S. 725, 732 n.7 (1974).

Finally, petitioners' reliance (Pet. 7-8) upon the mitigation provisions of the Internal Revenue Code of 1954 (Sections 1311 through 1314) is misplaced. Generally, the mitigation provisions afford the taxpayer (or the Commissioner) additional time to adjust certain errors in taxable years otherwise barred by the statute of limitations if those errors are inconsistent with a determination (defined in Section 1313) for another taxable year. If petitioners can prove that they treated an item on their returns for a time-barred year in a manner that is inconsistent with the Tax Court's decision here, and if they can prove that they meet the specific requirements of Sections 1311 and 1312, Section 1314(b) allows them to file a claim for refund with respect to the item inconsistently treated within one year from the date the Tax Court decision becomes final. Thus, at most, the mitigation provisions allow petitioners additional time to file refund claims. *Benenson* v. *United States,* 385 F. 2d 26, 31, 33-34 (2d Cir. 1967); *J.B.N. Telephone Co.* v. *United States,* 638 F. 2d 227, 236-237 (10th Cir. 1981). Treasury Regulations on Income Tax, Section 1.1314(b)-1(a) (26 C.F.R.).[5] If the Commissioner denies the claim, petitioners

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[5] *Moultrie Cotton Mills* v. *United States,* 151 F. Supp. 482 (Ct. Cl. 1957), holding that an additional refund claim for later years is unnecessary, is not to the contrary. In that case, the initial claim for refund covered all the years in issue and specifically invoked the mitigation provisions.

may then sue for a refund in the district court or in the Court of Claims. The crucial point to be made in this context is that the mitigation provisions do not allow the Tax Court to decide tax liability for years not properly before it, nor do they expand the Tax Court's statutory jurisdiction to include declaratory judgments or refund claims.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

MAY 1981

DOJ-1981-05